



TELSTRA CORPORATION LIMITED

PRICING PRINCIPLES FOR FIXED LINE SERVICES RESPONSE TO THE ACCC'S REQUEST FOR FURTHER INFORMATION

November 2010

TABLE OF CONTENTS

1.	Overview	3
2.	PSTN OTA Traffic	5
3.	Asset classes.....	8
4.	Asset Lives	15
5.	Operating Expenditure	16
6.	Capital Expenditure.....	19
7.	Indirect capital costs	23
8.	Weighted Average Cost of Capital (WACC)	25
9.	Depreciation	29
10.	Demand	31
11.	LSS and ULLS specific costs	35
12.	Real Economic Returns.....	37
13.	RAF Service Categories	40
14.	Schedules	41

1. OVERVIEW

1. In this document, Telstra responds directly to questions posed by the ACCC in its letter to Telstra received on 11 November 2010. In doing so, amongst other things, Telstra provides:
 - a. internal capital expenditure and demand forecasts – consistent with those used by Telstra for internal business planning and capital management purposes;
 - b. clarification of the way that certain asset classes and costs are treated in Telstra’s Regulated Accounting Framework (“**RAF**”) accounts as well as in its calculation of the depreciated indexed historical cost (“**DIHC**”) of Copper Access Network (“**CAN**”), Inter-Exchange Network (“**IEN**”) and related network assets included with its primary submission on 22 October 2010 in response to the ACCC’s Draft Report (the “**Original Submission**”);
 - c. explanations of Telstra’s approach to issues such as the calculation of the debt risk premium and total and remaining asset lives for use in any BBM; and
 - d. a fuller description of the calculation of Telstra’s real economic return on relevant assets, as referred to in its Original Submission.
2. Telstra is grateful for this opportunity to engage with the ACCC around the development of a BBM and, in particular, to assist it by providing further information and data, including demand and expenditure forecasts. In providing these demand and expenditure forecasts, in particular, Telstra notes that this response supplements evidence already provided which, amongst other things, sets out in some detail its demand and capital expenditure forecasting processes.¹
3. In light of statements made by the ACCC in its Draft Report, Telstra had anticipated a further, comprehensive consultation process (either as part of an RKR process or, preferably, in the course of developing a bespoke voluntary information regime for the BBM) to identify what further material, if any, Telstra would need to compile and provide to support its demand and expenditure forecasts.
4. In other regulated industries, the task of compiling material of this kind is substantial, especially at the outset of a regime. However, in its recent letter, the ACCC requested supporting material from Telstra within just seven working days.
5. Moreover, the nature of the BBM proposed by the ACCC raises other unique and complex issues not encountered in other industries which have adopted building block approaches. As Telstra explained in its Original Submission:
 - a. Telstra undertakes approximately 30,000 or more capital projects in relation to the CAN and IEN each year. Each project is driven by its own unique set of drivers and requirements. If the ACCC requires more detailed information than has been provided to date, Telstra will need to work with the ACCC to develop a way of explaining this extremely complex capital management task. It is not possible, within the timeframe proposed by the ACCC, to seek to properly or fully explain the drivers and business case for its entire capital budget in relation to the CAN and IEN.

¹ Telstra’s demand forecasting process was set out in section 5.5.2 of Telstra’s Original Submission. Telstra’s capital expenditure forecasting process was discussed in section 5.5.3 of Telstra’s Original Submission.

- b. Given that Telstra's internal forecasting processes do not align with the 4-year period currently proposed by the ACCC, Telstra only prepares detailed capital expenditure forecasts for one financial year ahead, with 2-year high level budget projections beyond that. These later projections are not supported by the same level of detailed analysis.
 - c. The ACCC has itself acknowledged that the Ovum BBM is not sensitive to capital expenditure forecast inputs. It follows that any information regime needs to be proportionate – imposing the least disruption and administrative cost on Telstra, the ACCC and other participants as is necessary.
6. Within these practical constraints, Telstra has sought in this response to give the ACCC as much detail and information as reasonably practicable. This includes providing its current capital forecast (for 2010-11) for the CAN and IEN as well as its view of high level capital expenditure trends as reflected in business planning projections for FY2011-12 and 2012-13 (in response to question 8). However, Telstra will require additional time to provide substantive material in support for its forecasts for capital expenditure, operating expenditure and demand.
7. To the extent that any additional material is needed, Telstra remains ready and willing to assist the ACCC and industry. However, in undertaking further consultation around these issues, Telstra requests that any process:
 - a. take into account the unique and complex nature of capital expenditure in relation to Telstra's CAN and IEN;
 - b. provides a reasonable and appropriate timeframe for compiling such material; and
 - c. balances the administrative burden and cost of the process with the sensitivity of the BBM (and indicative prices) to variations in the relevant inputs.
8. Finally, Telstra confirms that the material in this response (including all the Schedules) is highly sensitive to Telstra and is provided to the ACCC strictly on a commercial in confidence basis. Telstra provides this material on the understanding that the ACCC will not disclose any part of it to any other party.
9. The scope of the information in this response goes beyond that required to be provided by Telstra under existing regulatory arrangements, including under RAF and other Record Keeping Rule processes. Because of its sensitivity and detail, Telstra also provides it on the basis that the ACCC will not use it for any purpose, other than in connection with the current BBM/pricing principles process, without first notifying Telstra. This is necessary to ensure that Telstra is given an opportunity to explain and, if necessary, respond to use of this detailed data outside of the context of the RAB/pricing principles process.

2. PSTN OTA TRAFFIC

2.1. Background

10. In response to the ACCC's request for further information, Telstra has provided data on its PSTN OA and TA traffic for the period from May to October 2010. This data is set out in Telstra's response to Question 1 below.
11. Telstra is somewhat surprised by the ACCC's request for this data. Given that the ACCC has not requested similar data for LCS or for retail PSTN services, Telstra is concerned that the ACCC may be considering calculating wholesale-specific average call holding times ("**ACHT**") on the basis of PSTN OA and TA traffic only.
12. Telstra notes (and supports) the longstanding position taken by the ACCC that any calculation of indicative prices for PSTN OA and TA services based on ACHT for wholesale-only services would be inconsistent with the principle of cost recovery and the wider object of the long term interests of end-users ("**LTIE**").
13. As well as being consistent with the LTIE, maintaining the current rate table structure for PSTN OTA (which is based on established principles for cost recovery across all PSTN traffic) is important for maintaining price stability and regulatory predictability. A disruptive policy shift away from this past approach was not foreshadowed by the ACCC in the Draft Report and has not been the subject of any public consultation to date within the BBM process.

Calculating PSTN OTA traffic volumes and ACHT

14. In its submissions on the Draft Report and in other indicative pricing processes, Telstra has consistently supported the view that ACHT should be averaged across all services that use the PSTN, including local, STD and fixed to mobile calls and external wholesale minutes.² As discussed in Telstra's Original Submission³ (provided on 22 October 2010), in a letter to Telstra dated 7 October 2010, the ACCC indicated that for PSTN OTA:

"...actual traffic volumes were obtained from the RAF. They include retail call, domestic and international long distance, fixed to mobile minutes and external wholesale minutes, but exclude ISDN and dial-up minutes."

15. The costs of supplying call origination, carriage and termination over the PSTN are largely fixed and do not vary significantly with changes in call numbers or duration. This was recognised by the ACCC in its 2000 Review of Telstra's undertaking in respect of the Domestic PSTN OA and TA Services, which concluded (using the TSLRIC pricing model) that:⁴

"A 10 per cent increase in the number of call minutes (say under the assumption of greater call holding times) produces only approximately a 0.6 per cent increase in total conveyance costs."

16. The fixed costs incurred by Telstra are spread across all services supplied over the PSTN. In these circumstances, the only way of ensuring that Telstra is able to recover the efficient

² See for example, *Telstra's Submission in Support of its PSTN originating and terminating access and local carriage service Undertaking*, 22 March 2006, page 13.

³ See section 5.6.5.3 of Telstra's Original Submission.

⁴ ACCC, *A Report on the Assessment of Telstra's Undertaking for the Domestic PSTN Originating and Terminating Access Services*, section A1.2.1, page 47.

costs of providing these services is to calculate prices by reference to average traffic volumes and ACHT across all calls (both wholesale and retail). To do otherwise would be to allow wholesale customers the benefit of call origination, termination and carriage over a national fixed network without having to pay a share of the cost equivalent to all other (retail) consumers.

17. An outcome that ensures competitive neutrality between Telstra and access seekers and which provides for proper and efficient recovery of these fixed network costs is most consistent with the LTIE, as it encourages efficient investment in infrastructure and the promotion of sustainable competition.

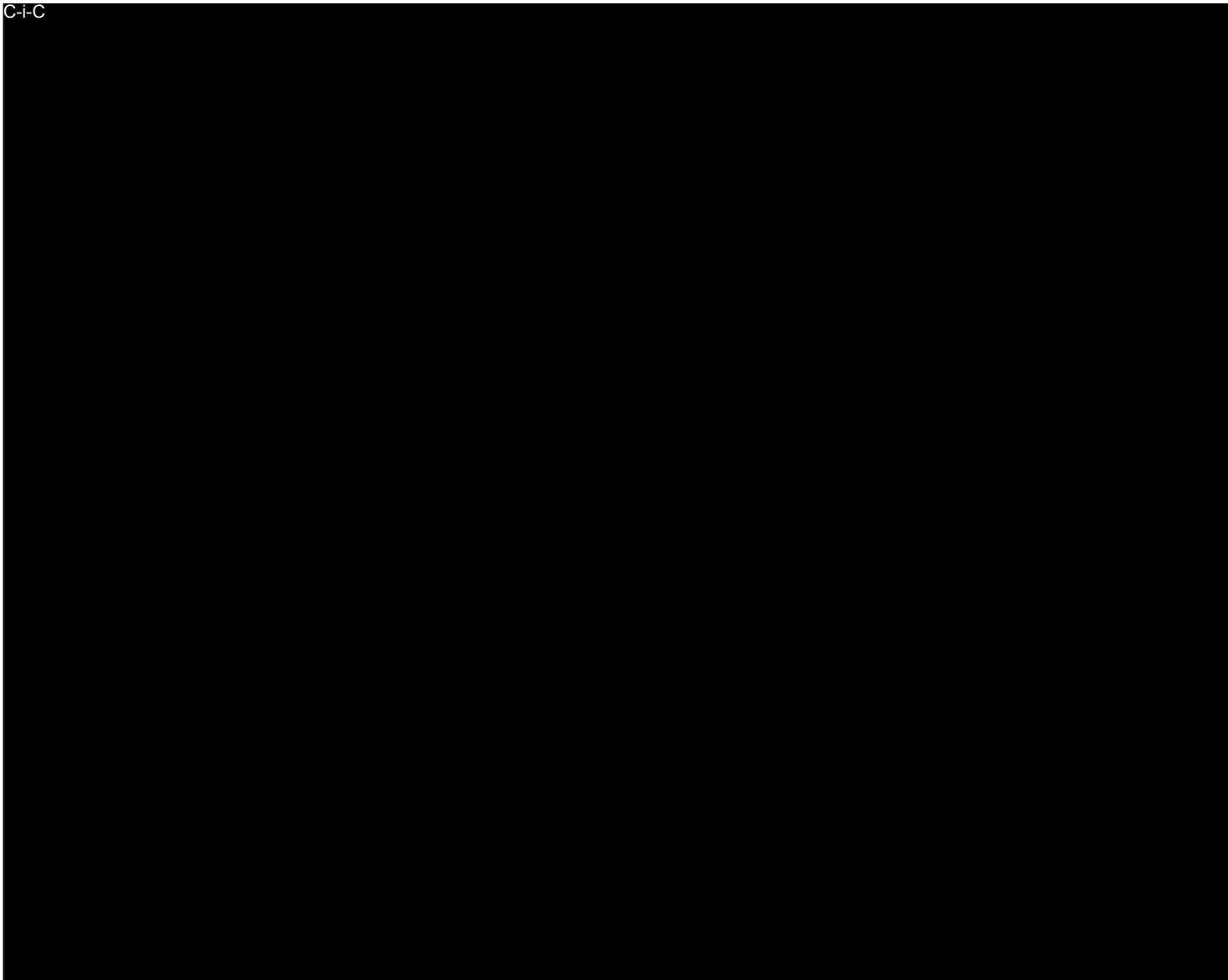
Q1. The ACCC requests that Telstra populates the following table for the most recent six months of data on OA and TA traffic by geographic area and average call duration.

18. Subject to the comments above, and as requested by the ACCC, Table 1 below shows PSTN OA and TA traffic volumes for the 6 months ending 31 October 2010. The table also shows aggregate PSTN traffic over this period.

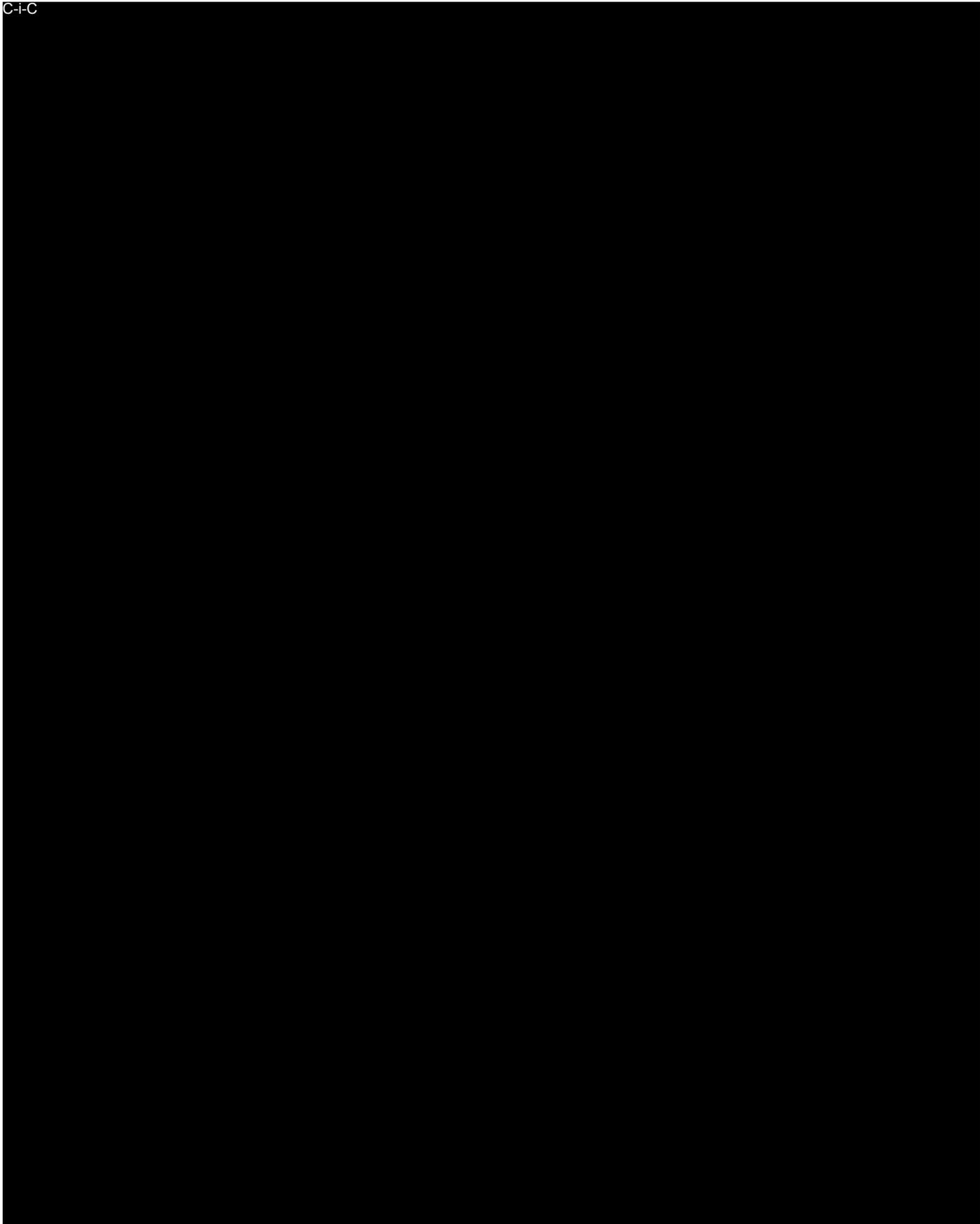
Table 1: PSTN traffic volumes (May - October 2010)

[c-i-c commences]

C-i-C



C-i-C



[c-i-c ends]

3. ASSET CLASSES

Q2. What assets, and the RAF asset classes where those assets are included, does Telstra consider should be excluded from the Ovum BBM? Where an asset is included within a broader asset class, the ACCC requests that Telstra identify the share (\$ or %) of the value of the asset class accounted for by that asset.

19. Table 9 of Telstra's Original Submission (provided on 22 October 2010) set out the DIHC of Telstra's CAN, IEN and network land, building and support assets.
20. In calculating the DIHC value of its CAN, IEN and network land, building and support assets, Telstra only included those assets that are used to provide ULLS, WLR, LSS, PSTN OTA and LCS. For example, Telstra's calculation included duct assets as they are used to provide both the services specified above and downstream retail services. However, Telstra's DIHC calculation excluded costs associated with international cables and other assets that are not used in the supply of the relevant services.

Network assets that should be excluded from the Ovum BBM

21. Schedule 1 to this response lists the network assets that were excluded from Telstra's DIHC calculation on the basis that they are not used to provide ULLS, WLR, LSS, PSTN OTA or LCS. Telstra considers that in order to ensure that a BBM is as cost orientated as possible, these assets ought to be excluded from the initial RAB in any BBM.
22. Schedule 1 is divided into 4 columns as follows:
 - **Cat**, which shows the Telstra code for the asset category;
 - **Account Description**, which describes the type of assets included in the relevant asset category;
 - **Asset Class Description**, which describes the relevant asset category; and
 - **RAF_Class**, which shows the line item the assets in the relevant category are allocated to for the purposes of producing the RAF.

Assets that should be included in the Ovum BBM

23. Again, in order to ensure that its DIHC value is as cost orientated as possible, Telstra included all of those network and non-network assets (e.g. indirect assets)⁵ used to supply ULLS, WLR, LSS, PSTN OTA or LCS. Schedule 2 to this response lists the network assets that were included in Telstra's DIHC calculations. Again, Telstra considers that a cost orientated BBM would need to include these assets.
24. Schedule 2 is divided into 6 columns as follows:
 - **Cat**, which shows the Telstra code for the asset category;
 - **Account Description**, which describes the type of assets included in the relevant asset category;
 - **Asset Class Description**, which describes the relevant asset category;

⁵ Non-network assets are discussed in greater detail in Telstra's response to Questions 11, 12 and 13 below.

- **RAB Asset Code**, which shows the line item the assets in the relevant category were allocated to for the purposes of calculating Telstra’s DIHC; and
- **RAF_Class**, which shows the line item the assets in the relevant category are allocated to for the purposes of producing the RAF. The use of a “0” in this column indicates that there is no specific line item for the asset category and that the assets are allocated across other RAF line items.⁶
- **Nominal Sum of WDV**, which shows the sum of the written down values (“**WDV**”) for each asset (regardless of vintage) included in the asset category, without any indexation to account for inflation. For example, the WDV of an asset purchased in 1979 is added to the WDV of an asset purchased in 2009 without any adjustment for inflation.

25. The sum of the “Nominal Sum of WDV” column in Schedule 2 reconciles to the sum of the written down value amounts in the “Input” worksheet of Telstra’s Confidential – (D)IHC calculation. However, the sum of the “Nominal Sum of WDV” column does not reconcile directly with RAF values because (i) as noted above, some RAF assets are excluded from Telstra’s indexed historic cost calculation because they are not used to provide the relevant services; and (b) the RAF allocates certain assets which are identified separately in the indexed historic cost calculation (e.g. network land, building and support assets) to other asset classes (e.g. ducts and pipes, copper cables etc).

The difference between tax and accounting asset values used as the basis for further KPMG analysis

26. [c-i-c commences] ^{C-I-C}

 [c-i-c ends]

Q3. The ACCC requests a reconciliation of the asset classes used in Telstra’s DIHC and the DORC RAB valuation sheet (provided with Telstra’s submission, email 1/10) with the asset classes from the RAF that are used in the Ovum BBM. Telstra should identify where the ‘Mux’ asset class is included in the RAF asset class and whether:

- **the ‘pair gains systems’ asset class in the RAF is included in Telstra’s valuation worksheets and, if not, provide an explanation for its exclusion**
- **the ‘satellite equipment and international network cables’ asset class in the RAF is included in Telstra’s valuation worksheets and, if not, provide an explanation for its exclusion.**

27. As discussed above, Schedule 2 to this response sets out the full list of those assets included in Telstra’s DIHC calculation and their corresponding RAF asset class references.

28. The DORC model values assets in a manner which is entirely separate from Telstra’s financial asset register. Therefore, there is no strict or necessary reconciliation between the assets valued in the DORC models and Telstra financial asset register. Despite this, the assets in the DORC calculations have asset codes attributed to them for the purpose of summarizing the

⁶ For example, the RAF does not separately identify network land, building and support assets. See discussion of this issue in section 4.8 of Telstra’s Original Submission (beginning on page 59).

results. This is only a loose attribution, as it serves no purpose other than to provide a summary of the results.

The "Mux" asset class

29. The detailed workings underlying the calculation of the DIHC value of Telstra's CAN, IEN and network land, building and support assets were set out in the spreadsheet titled "Telstra Confidential – (D)IHC Calculation" which was provided with Telstra's Original Submission (email 1/10). The CAN values listed in this spreadsheet included an amount for "Mux" assets.
30. The "Mux" asset category includes many assets which have a "Pair Gains Systems" Account Description in Telstra's financial asset register and/or a "CAN Pair Gains Systems" description in the RAF, but which should be included in the Ovum BBM as they are related to the supply of ULLS, WLR, LSS, PSTN OTA and/or LSC services. These assets are set out in rows 349-358, 361-389 and 429-432 (inclusive) of Schedule 2 to this response and include actual pair gains systems, line cards and CMUX equipment which is used to supply voice services such as WLR.
31. The "Mux" category does not include assets which have a "Pair Gain Systems" Account Description in Telstra's financial asset register and/or a CAN Pair Gains System categorization in the RAF, but which are not used to supply ULLS, WLR, LSS, PSTN OTA or LCS. These assets are set out in rows 2-86 (inclusive) of Schedule 1 to this response.

The 'pair gains systems' asset class

32. The "Pair Gains System" Account Description in Telstra's financial asset register and the "CAN Pair Gains Systems" asset class in the RAF include a broad range of assets, such as DSLAMs, Line Cards and actual Pair Gains Systems.
33. As indicated above, in calculating the DIHC value of its CAN, Telstra only included those assets falling within the "CAN Pair Gains Systems" asset class in the RAF which are used to supply ULLS, WLR, LSS, PSTN OTA and/or LCS. Telstra did not include CAN Pair Gains Systems assets that are not used (either wholly or in part) to supply these services.
34. The CAN Pair Gains Systems assets that were included in Telstra's calculations are set out in rows 349-390 (inclusive) of Schedule 2 to this response. The assets that were excluded from Telstra's calculations are set out in rows 2-86 (inclusive) of Schedule 1 to this response.

The 'satellite equipment and international network cables' asset class

35. Assets in the "international network cable" asset class were not included in Telstra's DIHC calculation at all as they are not used to supply ULLS, WLR, LSS, PSTN OTA or LCS.
36. Similarly, satellite equipment assets were not included as these assets are predominantly international, mobile and maritime satellite systems which are not used to supply ULLS, WLR, LSS, PSTN OTA or LCS. A small number of excluded satellite equipment assets are used to supply these services. However, Telstra is not able to easily identify those assets and has therefore adopted a conservative approach of excluding all satellite equipment assets from its calculations.

Q4. The ACCC also requests Telstra to identify which RAF asset classes include network land, building and support assets and specify separately the values of the network land assets, network building assets and network support assets in each RAF asset class. For network buildings and support assets, the total and remaining asset lives applied by Telstra to those assets should also be provided

Treatment and values of network land, building and support assets in the RAF

37. Network land, building and support assets are reported in three different asset categories in the RAF.
38. **Land** (including network related land) is dealt with in the RAF under asset category 2-3-20-4 of the RAF (under Other Non Current Assets). This category applies to all land (including freehold and perpetually renewable leasehold land) owned by Telstra. Note that the inclusion of network land into this asset category is a relatively recent development. Previously network land had been allocated across other categories of communication plant and equipment.
39. **Network Buildings** (such as huts, shelters and exchange buildings) are not reported separately but form part of RAF cost category Other Communications Plant & Equipment (2-1-90). This category also covers all network support structures (such as light, lifts and air conditioning) and power equipment. Improvements made to Network Buildings however are dealt with as part of the Buildings line item (2-2-03) – see below.
40. **Improvements on Network Buildings (and all non network buildings)** fall within asset category Buildings and Improvements 2-2-03-4 of the RAF (under Non Communications Plant & Equipment). This asset category covers all non network buildings owned by Telstra, including those under construction. It is also used for alterations, extensions, structural attachments, improvements associated with network and non-network buildings, as well as any improvements to leased buildings.
41. Where land, buildings and support costs can be identified directly with particular product groups, divisions, support units or organisational cost groupings, these are used. In all other cases, these costs are allocated using a suitable allocator. Typically, the allocator used will mirror the primary allocator used within the relevant cost item.
42. In the course of preparing this response to the ACCC's questions, Telstra has become aware that the scope of an error raised in its Original Submission is narrower than originally understood. Telstra raised a concern that the values applied to asset classes in the Ovum BBM were taken from the RAF accounts without separately identifying and dealing with depreciation of land, buildings and support assets. However, as noted above, all land and building improvement costs are treated separately in the RAF accounts. As such, Telstra withdraws the criticism made in section 4.8 of its Original Submission insofar as it relates to land and improvements. However, the criticism continues to apply in relation to network buildings and network support structures, which are not reported separately in the RAF.
43. Telstra notes that it had not attempted to quantify the value of this issue and so the quantification of revenue impacts identified in Table 5 at page 65 was not affected by this error.

Total and remaining asset lives for network building and support assets

44. For the purposes of its DORC calculation, Telstra uses the total and remaining lives estimated by RBB Economics in its expert report provided as Schedule 7 to Telstra's Original Submission.

45. As noted in response to question 16 below, and as set out in its Original Submission (at page 59) Telstra submits that it is not appropriate to depreciate land assets. On that basis, there is no applicable asset life for those assets.
46. For network building and support assets, Telstra uses the total and remaining lives estimated by RBB Economics in its expert report provided as Schedule 7 to Telstra's Original Submission. These are reproduced for network buildings and support assets in Table 2 below.

Table 2: Total and remaining lives for network building and support assets

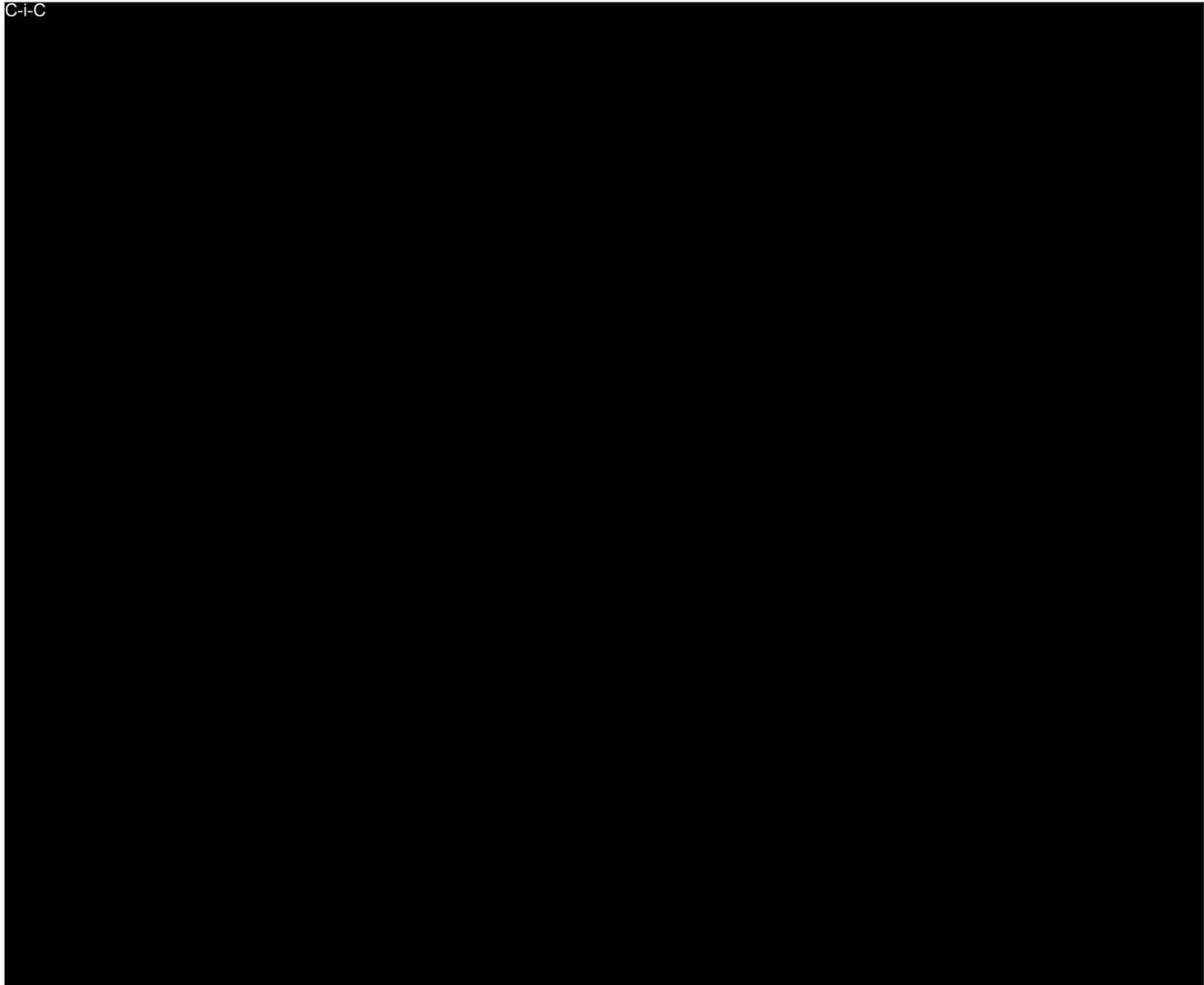
ASSET	TOTAL LIFE FOR NEW ASSETS	REMAINING LIFE FOR EXISTING ASSETS
Network buildings	[c-i-c commences] C-I-C	C-I-C
Network huts and shelters	C-I-C	C-I-C
Networks power	C-I-C	C-I-C [c-i-c ends]

Q5. Telstra's submission notes that some assets have been fully depreciated for accounting purposes (and removed from the asset register) but are still in active use. Please provide a list of these assets and a description of the source and reliability of this information.

47. Telstra's accounting policies provide for the application of three accounting methodologies to newly created assets as described below. The application of the methodology is set at the asset class level and defaults to all assets within that class.

[c-i-c commences]

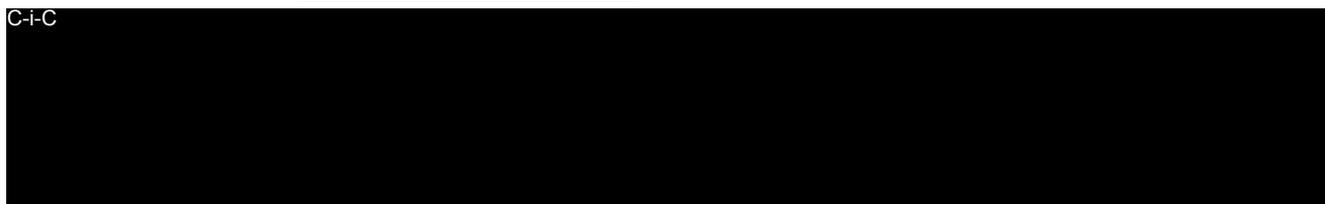
C-I-C



[c-i-c ends]

49. This means, in practice, that a large number of diverse assets will have been automatically retired from the asset register under Telstra’s accounting policies when they reached the end of their service life, even where those assets continue in service.

50. **[c-i-c commences]** [redacted]



C-i-C

⁷ **[c-i-c commences]** C-i-C [redacted]
[redacted] **[c-i-c ends]**

C-I-C

C-I-C C-I-C

[c-i-c ends]

51. However, given the size, scale and complexity of Telstra's network and physical assets, Telstra is not able to provide a comprehensive list of all assets that are still in active use, but which have been retired for accounting purposes. To produce such a list, Telstra would have to undertake a detailed, nationwide audit of its network and physical assets and reconcile the results of that audit with the asset included in the RAF accounts, which is not practical.
52. Rather, the existence of these types of assets highlights why it is not likely to be possible for the ACCC to form an accurate view about the economic value of the CAN and IEN from their written down values in the RAF. This issue is discussed in greater detail in Telstra's Original Submission (provided on 22 October 2010) and is referred to by Bruce Porter in his expert report.⁸

⁸ See section 4.3.2 of Telstra's Original Response and Schedule 2.

4. ASSET LIVES

Q6. What are the total and average remaining asset lives of the asset classes provided by Telstra in the Telstra Confidentiality – (D)IHC calculation workbook? Explain the basis for determining the total and average remaining asset lives.

53. The DIHC calculation undertaken by Telstra does not rely on any specific assumptions regarding asset lives.
54. For the purpose of calculating the DIHC value of its assets, Telstra determines the amount of depreciation in each year by dividing the accumulated depreciation for each vintage of assets (sourced from Telstra's financial asset register) by the age of that vintage. For example, if the accumulated depreciation of assets of the vintage 30 June 2009 is \$6 and those assets were purchased on 30 June 2003, the depreciation in each year would be \$1 (i.e. \$6/6 years).
55. As can be seen, the calculation of the DIHC value of Telstra's assets depends on the written down value of Telstra's assets and the age of each vintage of asset. The calculation does not make any assumptions about the total or average remaining lives of Telstra's assets.

5. OPERATING EXPENDITURE

Q7. The ACCC seeks confirmation from Telstra that indirect operating expenditures are included in the RAF under '4-1 Organisation' and '4-2 Product and Customer'. Explain how Telstra allocates these costs to service categories.

Treatment of indirect operating expenditures in the RAF

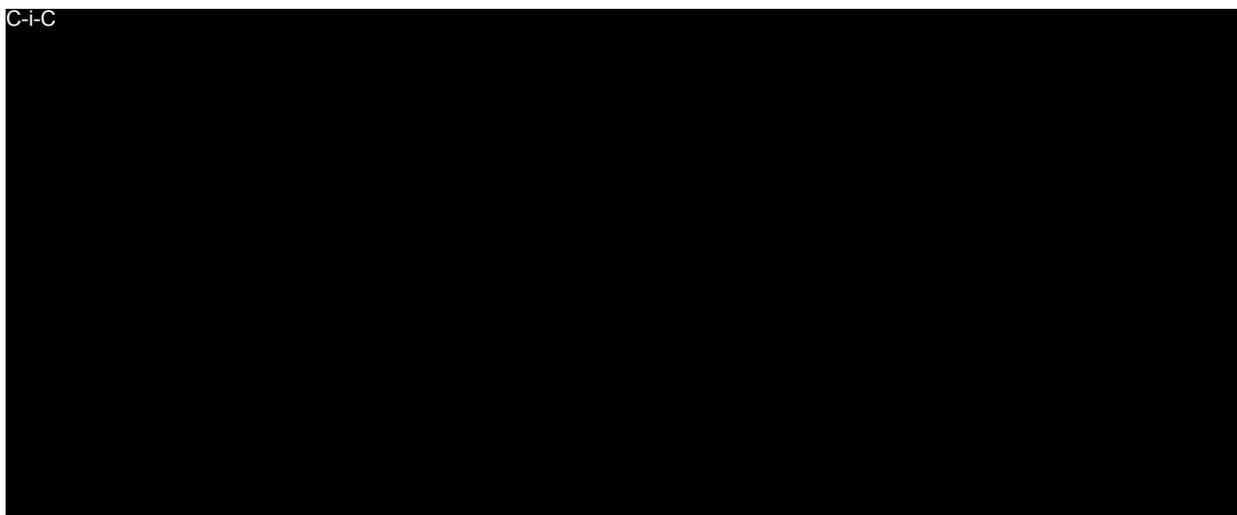
56. Telstra can confirm that indirect operating costs are included under cost categories '4-1 Organisation' and '4-2 Product and Customer' in the RAF accounts. Although, by far the greater proportion of this expenditure is incurred under '4-1 Organisation'.
57. A brief description of each of these and the other RAF cost categories and the allocation rules that apply in preparing the RAF accounts is set out in the RAPM. While Telstra is aware that the ACCC has a copy of the RAPM, a further copy is attached in Schedule 3. In relation to these categories, in particular, Telstra refers the ACCC to pages 28-32 of the RAPM.
58. To assist the ACCC, Telstra has also set out in Schedule 4 a full summary of operating expenditure, both direct and indirect, with references to the relevant RAF cost categories and as allocated in the RAF across the relevant fixed services.
59. As the list in Schedule 4 highlights, the following operating expenditure categories should not have been included in the Ovum BBM because they are not relevant:
 - a. Installation (4-2-01)
 - b. Operator Services (4-2-20)
 - c. USO Payments (4-2-60)

Allocation of indirect operating expenditure between service categories

60. The general allocation principles that are applied by Telstra in preparing the RAF are consistent for all forms of operating expenditure, being that:

[c-i-c commences]

C-I-C

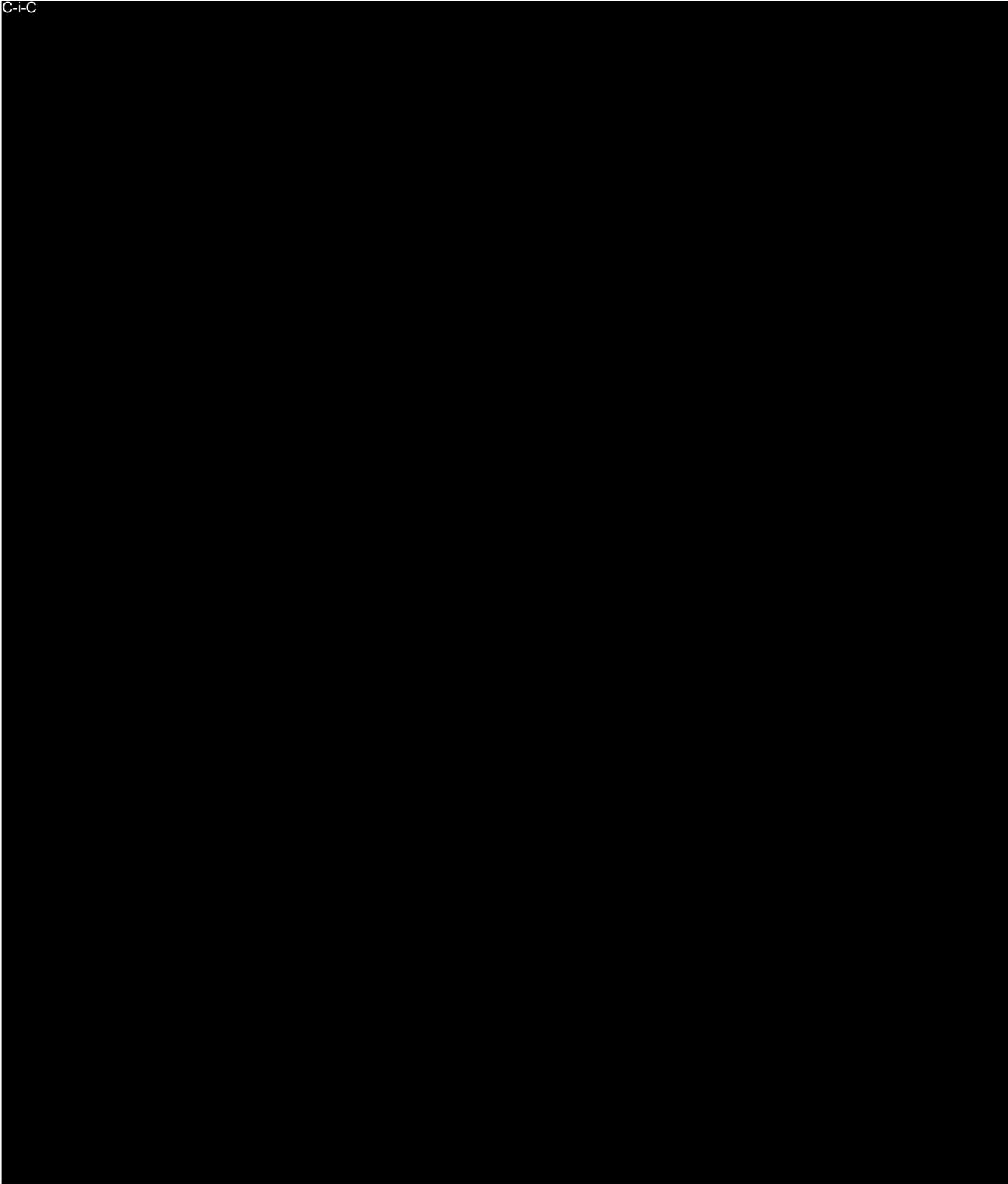


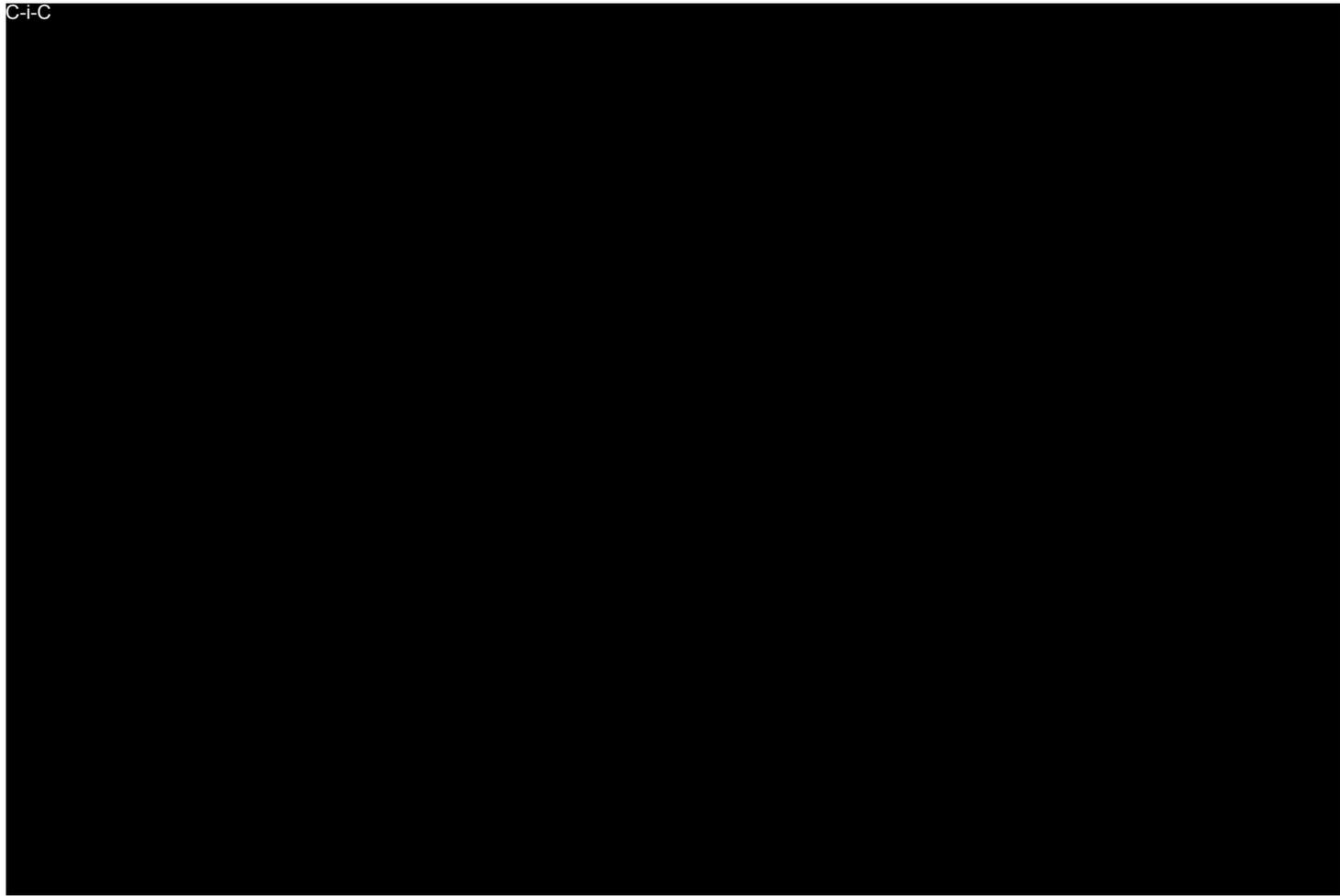
[c-i-c ends]

61. The specific allocation methods applied to each of the indirect operating cost categories listed in Schedule 4 is summarised as follows (as taken from the RAPM):

[c-i-c commences]

C-I-C





[c-i-c ends]

77. The primary study used to allocate indirect network operating expenses, such as depreciation and maintenance is the Joint Network Cost Model ("**JNCM**"). For further detailed information in relation to the JNCM, Telstra refers the ACCC to Attachment 7.3 to the RAPM, previously provided to the ACCC by Telstra.

6. CAPITAL EXPENDITURE

Q8 The ACCC requests that Telstra suggests alternative capital expenditure forecasts that it considers more appropriate. Telstra should explain the basis for its forecasts by relating them to the drivers of capital expenditure and explaining the factors taken into account in developing the forecasts. If possible, it would be helpful for separate explanations to be provided for 'baseline' projects and 'discretionary' projects. Any forecast impacts from the roll-out of the NBN should be identified and explained.

Telstra capital expenditure forecasts

78. As set out in the Overview above, given the seven day timeframe within which the ACCC has sought a response, Telstra is simply not in a position to provide a detailed justification for its entire CAN and IEN capital expenditure program (of over 30,000 individual projects).
79. Moreover, as noted in its Original Submission,⁹ Telstra does not produce internal capital expenditure forecasts for the four-year period which the ACCC has proposed in relation to its draft pricing principles and indicative prices.
80. Telstra is nonetheless committed to assisting the ACCC to the extent that it reasonably can, and within these constraints. Telstra capital management process has two general levels of capital forecasting:
- detailed 'bottom up' planning is done at a project level in arriving at the current year's budget (2010-11); and
 - higher level business projections for capital expenditure are done in relation to years two and three, beyond the end of the current financial year (that is, 2011-12 and 2012-13).
81. In Schedule 5 Telstra provides a breakdown of its actual capital expenditure for FY2009-10 and detailed capital expenditure forecasts for FY2010-11, which have been prepared using the capital planning and management process set out in the Original Submission (at pages 99-101).¹⁰
82. Given the detailed planning that underpins the current budget year forecast, Telstra is providing the capex forecast for 2010-11 by asset category (for those direct asset categories relevant to the RAB). This information is also cross-tabulated, for information purposes, by a number of dashboard categories – IEN, integrated access, wideband, land & buildings and other.
83. It should also be noted that the capital expenditure actuals and forecasts set out in Schedule 5:

⁹ See pages 93-94.

¹⁰ [c-i-c commences] C-I-C

[c-i-c ends]

- a. do not include any allowance for capitalised interest; and
 - b. relate only to those asset categories included in the RAB, and where an asset category is only partly included in the RAB, it is included in the capital expenditure forecast on an equivalent basis (i.e. the forecast has been adjusted to reflect the proportion of the cost allocated to the RAB). There are [c-i-c commences] [c-i-c ends] such partly included asset categories, and the percentage excluded is as follows: [c-i-c commences] [c-i-c ends].
84. As set out in Schedule 5, the total capital expenditure across relevant asset categories for:
- a. 2009-10 financial year was approximately [c-i-c commences] [c-i-c ends]; and
 - b. the current 2010-11 financial year is approximately [c-i-c commences] [c-i-c ends].
85. Beyond the current financial year, Telstra's 2-3 year forward projections are for flattish capital expenditure. Because of the high level nature of the planning over this longer period, the total amounts do not relate directly to the scope of capital expenditure relevant to the RAB. [c-i-c commences] [c-i-c ends]. These projections also take into account the (relatively limited) impact of NBN on such expenditure that is expected over this period.

Drivers of capital expenditure

86. [c-i-c commences] [c-i-c ends]
87. [c-i-c commences] [c-i-c ends]
88. While Telstra is not in a position to provide detailed information about drivers for all of its capital program, the following general factors typically drive baseline capital spending of the kind which is currently being incurred under [c-i-c commences] [c-i-c ends]:
- a. customer demand (new estates, redevelopment, customer orders);
 - b. capacity augmentation (to cope in particular with increased backhaul requirements); and
 - c. asset replacement and operational support (including compliance with relevant regulatory requirements such as the Network Reliability Framework).
89. In addition, a further key factor affecting Telstra's current capital program has been the regulatory uncertainty surrounding greenfields fibre in new estates. Given this uncertainty, Telstra has sought to delay installing copper infrastructure in new estates, instead making fibre ready investments in passive (duct, pit and manhole) infrastructure. This has had the effect of lowering Telstra's expenditure on copper cables, but without a commensurate increase in fibre cable investment for the time being. Telstra expects to see some change in

its future capital expenditure as greater regulatory certainty is provided around greenfields fibre in new estates.

Conclusions

90. Telstra submits that the detailed capital expenditure forecasts and supporting material now provided highlight that there is little to be gained from the ACCC pressing ahead with a heavy-handed capital expenditure information and review regime.

91. To the contrary, it can now be seen that:

- a. the BBM proposed by the ACCC is not sensitive to variations in capital expenditure inputs;
- b. Telstra's actual and forecast capital expenditure across relevant asset categories is considerably lower than historical levels (and the ACCC's own estimates);
- c. the current capital expenditure outlook is stable; and

d. [c-i-c commences]

[c-i-c ends]

92. In this context, Telstra maintains that a practical and 'workable' approach to dealing with capital expenditure is called for as part of the BBM process. To assist with this process, Telstra is currently working on more detailed capital expenditure projections for 2011/12 and 2012/13. These will not be based on the sort of bottom up planning that underpins the current budget year forecast, but would be presented on an asset category basis. These can be provided to the ACCC as soon as they are finalised.

Q9. The annual capital expenditure for the CAN and Core asset categories included in Telstra's 2005-06 to 2009-10 annual reports are significantly greater than the annual capital expenditure amounts included in Telstra's RAB valuation spreadsheets for the CAN and the Core. The ACCC requests a reconciliation of these amounts.

93. At least two key factors cause the capital expenditure recorded in Telstra's RAB valuation spreadsheet to differ from that included in Telstra's annual reports.

94. First, and most significantly, Telstra's RAB valuation spreadsheet only includes those assets which are used (in whole or in part) to supply ULLS, WLR, LSS, PSTN OTA and/or LCS. As discussed in the response to Questions 2 and 3 above, these assets represent a subset of the assets recorded in the RAF. This is necessary in order to ensure that the initial RAB is cost orientated.

95. Second, there may be a difference in the time at which capital expenditure is recorded in Telstra's RAB valuation spreadsheets and annual reports. However, as indicated in Telstra's memo to the ACCC, this difference is likely to have a relatively minor impact.¹¹

¹¹ Telstra comments in response to ACCC proposal to determine RAB capital expenditure estimates and forecasts from RAF asset values, 13 August 2010.

Q10. Telstra's RAB valuation spreadsheets do not include the 'pair gain systems', 'satellite equipment' and 'international network cable' asset classes, which are included in the RAF and the Ovum BBM. What is the capital expenditure related to these asset classes?

96. The current value of capital for the satellite equipment and international network cable asset classes are set out in the RAF. For included pair gain systems, see the response to Question 2 above.
97. Telstra has not prepared forecasts of future capital expenditure for these assets as Telstra considers that they should not be included in the BBM. This is because, as discussed in response to Questions 2 and 3 above, they are not used to supply ULLS, WLR, LSS, PSTN OTA and LCS.

7. INDIRECT CAPITAL COSTS

Q11. The ACCC requests a definition of the nature of the expenditures classified as indirect capital expenditures by Telstra.

98. In its Original Submission (provided on 22 October 2010), Telstra expressed concern that the capital amounts used in the Ovum BBM do not make any allowance for indirect capital costs. In this regard, Telstra notes that the ACCC's capital forecasts only include a subset of the communications plant and equipment asset classes in the RAF. The ACCC's forecasts do not include any non-communications plant and equipment assets.
99. Telstra defines "indirect capital expenditure" as capital expenditure which is incurred in the supply of any service or group of services, but which is not causally related to any service. For example, capital expenditure associated with human relations or accounting functions would be indirect capital expenditure as it is not causally related to, but is needed for, the supply of ULLS, WLR, LSS, PSTN OTA and/or LCS.
100. Telstra notes that its definition of "indirect capital expenditure" is unlikely to cover all capital which the ACCC has incorrectly excluded from the Ovum BBM. For example, some expenditure on IT systems might be direct capital expenditure (and therefore fall outside the above definition of indirect capital expenditure). However, this expenditure has not been included in the Ovum BBM as it does not fall within the communications plant and equipment asset classes in the RAF.
101. As discussed in response to Question 2 above, Schedule 2 to this response lists all of the assets Telstra considers should be included in the Ovum BBM.

Q12. Telstra is asked to identify where these 'indirect capital expenditures' are included in the RAF and which asset classes they relate to.

102. The general principles of allocation for indirect operating expenditure (set out in response to question 7) also apply in relation to the principles used to allocate indirect capital expenditure.
103. Indirect capital expenditure is reported on in the RAF under cost categories:
- a. 2-2 Non Communications Plant and Equipment
 - b. 2-3 Other Non Current Assets
104. The cost values allocated to these categories in the RAF accounts over the last five years are set out in Schedule 6.

Q13. The ACCC requests that Telstra proposes forecasts for indirect capital expenditure that it considers appropriate (for the period over which it believes it can identify robust forecasts). Telstra should explain the basis of these forecasts.

105. Telstra considers that the ACCC should use a factor based approach for determining future values for indirect capital.
106. Telstra previously calculated the ratio of indirect capital to network capital in the last indicative pricing process.¹² The ratio of indirect capital to direct capital (un-depreciated) is

¹² See: *Telstra Corporation Limited, Response to the ACCC's draft pricing principles and indicative prices for LCS, WLR, PSTN OTA, ULLS, LSS*, 9 October 2009, Attachment B, page 73.

[c-i-c commences] C-I-C **[c-i-c ends]**. The factor study which Telstra relied on in reaching that figure is set out in Schedule 7. This factor is consistent with international benchmarking undertaken on behalf of Telstra by Nigel Attenborough (of NERA) in 2009. Mr Attenborough's expert report is attached at Schedule 8.

107. The information provided in response to Question 12 above would enable the ACCC to determine in a similar way a factor on the basis of *depreciated* capital. This factor may be more suitable to apply in the Ovum BBM, which is based on depreciated capital values.
108. Telstra has determined factor values on this basis over each of the last five financial years, as set out in Schedule 7.

8. WEIGHTED AVERAGE COST OF CAPITAL (WACC)

Q14 Telstra's submission has proposed an alternative method of calculating the debt risk premium but has not explained how it proposes to calculate a Telstra-specific DRP. How does Telstra propose to estimate the DRP? Please provide an explanation of the proposed methodology, data sources and estimated value.

Telstra's proposed methodology and data sources for calculating the debt risk premium

109. The DRP that is relevant in this context is that which would apply to a stand-alone provider of the CAN. While a CAN-specific DRP is not directly observable, the Telstra-wide DRP is a suitable guide that can be used in the first instance, and benchmarking can be used as a reasonableness check.
110. The methodology that Telstra proposes in calculating the DRP for a stand-alone provider of the CAN is reasonably similar to that for finding the CAN-specific asset beta. Further, as the DRP is a market driven parameter that potentially exhibits high volatility, any estimation should take into account similar considerations as applied in the estimation of the risk-free rate.
111. Some degree of judgment is required in determining an estimate of the DRP for a stand-alone provider of the CAN. The proposed process can be broadly outlined in three steps:
- a. A range for the Telstra wide DRP is estimated.
 - b. Qualitative adjustments are considered and/or made to reflect any specific risks associated with the CAN.
 - c. Benchmarking is used, with some similar type of adjustment being made where appropriate.
112. Telstra is of the view that Telstra-wide information will usually be the most useful and appropriate starting point for quantifying CAN-specific values for WACC parameters.
113. In relation to the Telstra wide DRP two pieces of information with multiple sources are used:
- a. The average Telstra corporate bond rate sourced from 8 independent banks; and,
 - b. A 10-year commonwealth government bond rate as a proxy for the risk-free rate, sourced from the RBA.
114. From this information the DRP can be calculated as the margin of the Telstra corporate bond above the risk-free rate proxy. The methodology for calculating each of the components is outlined in turn.
115. Telstra (wide) Bond Yields are derived by a process of price discovery by Telstra at the end of each quarter or sooner should significant events occur. The quotes are collected as a margin over the basic bank Swap Curve. By adding this margin to the Swap Curve Yield for each term, Telstra derives an all up Yield over Swap. This can, in turn, be compared against equivalent Government Bond Yields to determine the Telstra wide DRP over Government Bonds.
116. The Telstra corporate bond rate is sourced from 8 independent bank estimates; provided at quarter end and receiving estimates for Telstra bonds with a 3, 5, 7 and 10-year yield to maturity. If all eight 8 quotes are available at quarter end, the maximum and minimum

quotes are removed and the arithmetic average of the remaining 6 quotes is calculated as the appropriate measure of the relevant Telstra corporate bond rate for each term.

117. The methodology outlined in above provides an estimate of the appropriate margin Telstra pays for borrowing over the Swap Rate on a quarterly basis. To obtain a daily approximation, Telstra adds this margin to the end of day swap rate to derive Telstra corporate bond's yield to maturity. A yield to maturity of 10-years is used as a proxy for the Telstra corporate bond rate.
118. Telstra proposes that the estimation of the risk-free rate must be a 10-year Commonwealth Government bond for similar reasons as those outlined in Telstra's Original Submission (at page 82), such as:
 - a. appropriately matching the yield to maturity of long-term debt;
 - b. reflects the consistent practice of Australian regulatory bodies; and,
 - c. is consistent with the funding approach actually employed by Telstra.
119. Further, due to fluctuations in the market for debt and government bonds, the approach to estimating the risk-free rate in Telstra's Original Submission pg. 82-83 must be extended to the calculation of the DRP.
120. Specifically, Telstra proposes that, to deal with the fluctuations, the approach of the AER to estimating the risk-free rate also be applied to the DRP. That is, in each case, Telstra would nominate:
 - a. the length of the averaging period (usually 20 to 40 day trailing average);
 - b. the point in time over which the nominated averaging period should be taken; and,
 - c. to have that average then apply from the beginning of the regulatory control period.
121. As with the risk-free rate, the DRP is a potentially volatile market driven parameter. In these circumstances, it is important to ensure that the parameter value chosen does not lead to an estimate of the WACC that is unrepresentative of the rate of return required over the whole of the regulatory period. For this reason, the ACCC should consider, in the case of more extreme circumstances, having the flexibility to take a similar approach to that outlined by Ofcom. In times of intense market uncertainty and turbulence, the UK telecoms regulator has adopted the principle of giving greater weight to longer term averages for the risk-free rate and DRP than spot rates.¹³
122. Once a Telstra-wide DRP range is determined, this needs to be adjusted to take into account the unique risk of default that is faced by a CAN-only provider. Determining the level of any such adjustment is necessarily a subjective process. What is more practical is to determine the general level of default risk of a CAN-only provider relative to Telstra as a whole and use this comparison as a guide to determine if a CAN-only DRP should be higher or lower than the Telstra wide DRP. This general outcome can then be cross checked against the results of benchmarking.
123. Telstra believes that a CAN-only provider will face a higher risk of default relative to Telstra as a whole due to the following factors:

¹³ Ofcom, *A New Pricing framework for Openreach*, 2009 Annexes, 22 May 2009, page 172, paragraph A8.128.

- a. demand for products and services delivered over Telstra's CAN have been decreasing – with associated impacts on revenues;
- b. the CAN is the central critical asset within Telstra and most products and services provided by Telstra will traverse the CAN or are in some manner dependent on the CAN. Therefore, the CAN is central in the provision of all of these and thus subject in varying degrees to the systematic riskiness of all these products; and,
- c. the imminent stranding of the CAN that will arise from NBN Co's fibre network build, and the uncertainty associated with the rate of traffic migration away from the CAN as NBN's network is built out.

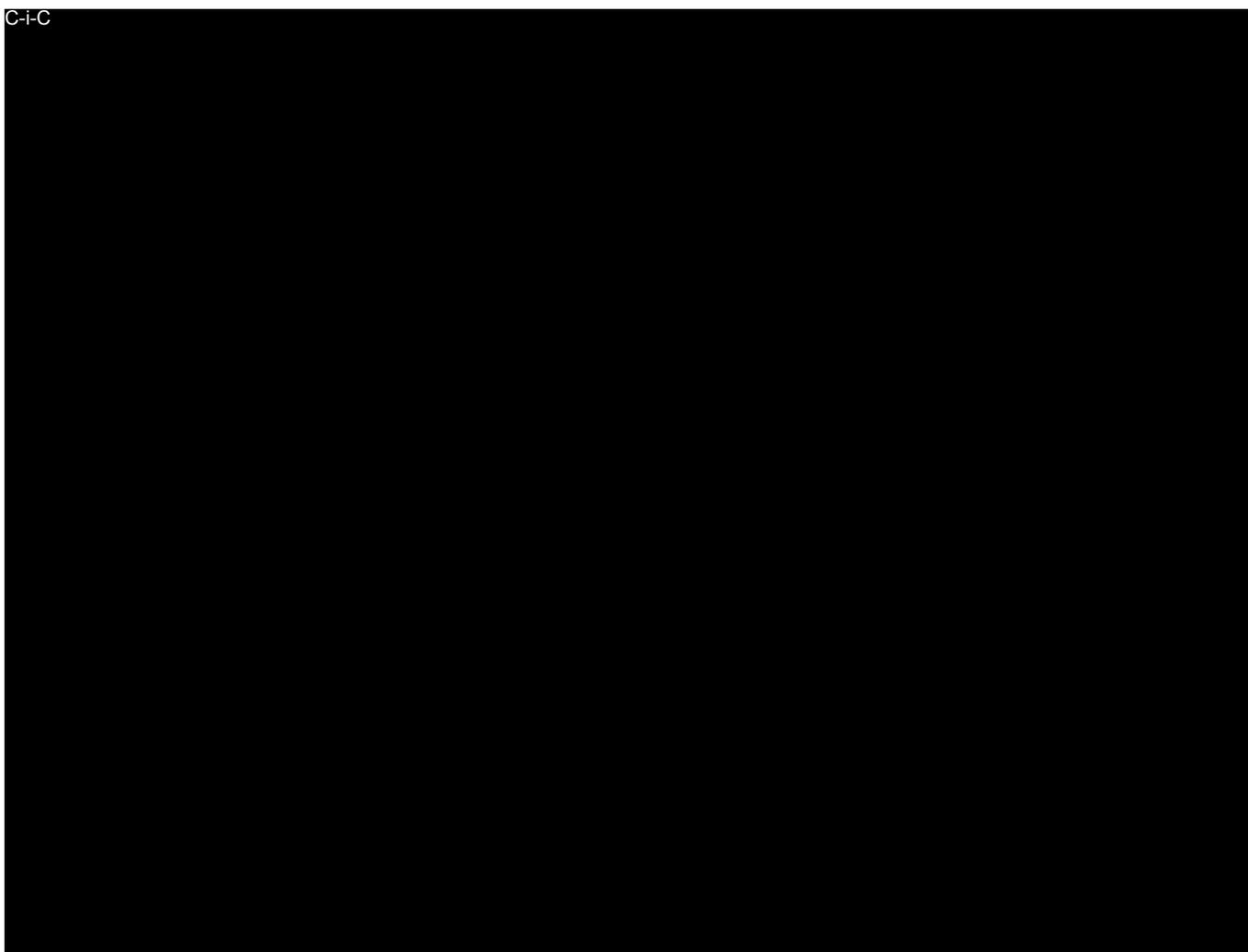
124. Finally once the DRP range for a CAN-only provider is arrived at, the result should be compared with the outcome of benchmarking, to determine the reasonableness of the range. Telstra considers that for benchmarking to be conducted appropriately all of the issues raised in the Original Submission page 84 regarding benchmarking of the DRP would need to be addressed.

Telstra's estimated DRP range

125. The Telstra wide DRP for the period 1st June 2004 to 30th June 2010 is shown in Figure 1.

Figure 1: Telstra wide DRP

[c-i-c commences]



c.

[c-i-c ends].

127. By placing greater weight on the more recent history, the range for the true Telstra wide DRP is determined to be between [c-i-c commences] [c-i-c ends], with a simple average of [c-i-c commences] [c-i-c ends].
128. For the reasons mentioned above Telstra believes that a CAN-only provider will face a higher level of risk than Telstra as a whole. However the magnitude of this risk is not quantifiable and requires a degree of subjective adjustment. This means the range of the DRP for a CAN-only provider will have upper and lower bound values that are greater than the [c-i-c commences] [c-i-c ends] that were calculated for Telstra.
129. Setting aside any methodological concerns that Telstra has previously raised in regard to the ACCC's benchmarking the Original Submission pg. 84, the ACCC's benchmarking shows that a value of 3.06% is an appropriate value for a Telstra wide DRP. This value is in the range of [c-i-c commences] [c-i-c ends], and given the upward adjustments required for the risks associated with a CAN-only provider, the choice of 3.06% is considered to be a reasonable estimate for the DRP.

9. DEPRECIATION

Q15 The ACCC requests detailed workings supporting the depreciation estimates referred to in para. 132 (p. 42 of its submission)

130. In paragraph 132 of its original submission, Telstra estimated the amount of depreciation the ACCC has allowed Telstra to recover on assets purchased since 1999/00. Telstra also estimated the amount of accounting depreciation that has been booked against the value of those assets in the RAF accounts.
131. The detailed workings underlying Telstra’s depreciation calculations are set out in the “Example Used in Submission” worksheet in Schedule 9 to this response. As can be seen, the calculation is based on three key values, namely:
- **Capital added**, which shows the amount of capital added to Telstra’s asset register in each vintage from 1999/00 2008/09;
 - **Accounting Accumulated Depreciation**, which shows the depreciation for each vintage of capital accumulated over the period from the date on which the capital was added to 30 June 2009; and
 - **Allowed Accumulated Depreciation**, which applies the ACCC’s titled annuity formula (used in determining access prices¹⁴) to the value of capital purchased in each vintage.
132. The example in Telstra’s Original Submission was constructed prior to Telstra calculating indexed historic costs. Telstra now provides an alternative version of the example (set out in the “Example Reconciled to IHC” worksheet in Schedule 9) which reconciles to the inputs used in Telstra’s indexed historic cost calculation.
133. Table 3 below compares the amount of depreciation calculated using the methodology adopted in Telstra’s Original Submission and the alternative methodology set out in the “Example Reconciled to IHC” worksheet in Schedule 9. The difference between the values is primarily due to different assets being included in the calculations.

Table 3: Estimate of allowed and accounting depreciation

	EXAMPLE IN TELSTRA’S ORIGINAL SUBMISSION	EXAMPLE RECONCILED TO TELSTRA’S DIHC CALCULATION
Value of capital added to the asset register since 1999/00	[c-i-c commences] C-I-C	C-I-C
Value of accounting depreciation booked against the value of assets in the RAF accounts	C-I-C	C-I-C

¹⁴ See ACCC, *ULLS Access Dispute Between Telstra and Primus (Monthly Charges: Statement of Reasons for Final Determination)*, December 2007. The price trends were taken from paragraph 419 where there was a corresponding asset category, or zero otherwise. Asset lives were taken from the ACCC’s version of the PIE model used for the same decision.

	EXAMPLE IN TELSTRA'S ORIGINAL SUBMISSION	EXAMPLE RECONCILED TO TELSTRA'S DIHC CALCULATION
Value of depreciation allowed by the ACCC	C-I-C	C-I-C
Depreciation recorded in the RAF accounts but not allowed under the titled annuity depreciation profile	C-I-C	C-I-C [c-i-c ends]

Q16. Telstra's submission states that land should not be depreciated in the Ovum BBM (p.59) because it appreciates in value. The ACCC notes that Telstra's asset register records amounts for depreciation against its network land category, particularly since 1990. Please explain this apparent depreciation of land in the asset register.

134. Telstra's calculation of indexed historic cost includes a category of assets that Telstra has titled "Network Land", a category made up of a number of "Asset Classes" in Telstra's financial asset register.

135. There are a small number of those asset classes which Telstra is entitled to depreciate in accordance with accounting standards. However, of the assets in the "Network Land" category, Telstra is entitled to depreciate only [c-i-c commences] C-I-C [c-i-c ends] of them (by total nominal value). These assets are predominately land improvements, such as fencing, storm water drainage, roads and paths etc.

136. The remaining [c-i-c commences] C-I-C [c-i-c ends] of the nominal value of assets in the "network Land" category are not depreciating. In total, accumulated depreciation amounts to under [c-i-c commences] C-I-C [c-i-c ends] of the nominal historic purchase cost of all assets in the "Network Land" category in Telstra's financial asset register.

137. For this reason, while a small proportion of the Network Land category is depreciated, this depreciation is marginal and does not provide any justification for depreciating land itself.

10. DEMAND

Q17. The ACCC requests that Telstra suggest alternative demand forecasts that it considers more appropriate and requests an explanation of the basis for Telstra's forecasts, including a discussion of the main drivers for demand for the declared fixed line services. It also requests an explanation of the demand adjustments Telstra considers are needed to account for the roll-out of the NBN and Telstra's assessment of the degree of uncertainty attached to these forecasts.

138. Telstra has previously provided the ACCC with significant information in relation to its demand forecasting process and the key factors it considers are likely to affect demand for CAN and IEN services during the initial regulatory period. For example:
- Part 5.5.2 of Telstra's Original Submission (provided on 22 October 2010) included a detailed discussion of Telstra's demand forecasting methodology, including the key factors or "drivers" Telstra considers when forecasting demand for CAN and IEN services;
 - Part 5.5.5 of Telstra's Original Submission discussed the likely impact of the NBN roll-out on demand for Telstra's fixed line services and included an estimate (based on the National Broadband Network Implementation Study (**NBN Implementation Study**)) of the number of premises that will be migrated from Telstra's CAN during the first regulatory period;
 - Part 2.1 of Telstra's Supplementary Submission (provided on 11 November 2010) discussed the key drivers of demand for CAN services and the likely impact of fixed-to-mobile substitution and the increasing penetration of IP/broadband based telephony on demand for fixed line services; and
 - Part 2.3 of Telstra's Supplementary Submission set out Telstra's actual PSTN LCS minutes of usage for the years from 2002/03 to 2009/10.
139. In response to the ACCC's most recent request for further information, Telstra now provides its demand forecasts for the period from 2010/11 to 2012/13.
140. As previously explained, Telstra is not in a position to forecast demand for the four year regulatory period proposed by the ACCC. Instead, Telstra only forecasts demand over three year periods for its own internal business purposes. Telstra now provides the ACCC with its internal demand forecasts for CAN and IEN services for the period from 2010/11 to 2012/13, as set out in Table 4 below.
141. While required to forecast demand over three year periods for its own internal business and planning purposes, Telstra considers that, given the high degree of uncertainty in the telecommunications sector, its demand forecasts for future years are likely to be subject to variation. For this reason, Telstra regularly compares its forecasts with actuals and updates its models and assumptions as required.¹⁵
142. In these circumstances, Telstra is concerned that its current demand forecasts for 2012/13 may subsequently prove to be incorrect and therefore cause the indicative prices produced by the Ovum BBM to be incorrect. This problem could be avoided by adopting a shorter regulatory period (such as the 2 year period proposed in Telstra's Original Submission¹⁶). At

¹⁵ This revision process is discussed in greater detail in section 5.5.2 of Telstra's Original Submission.

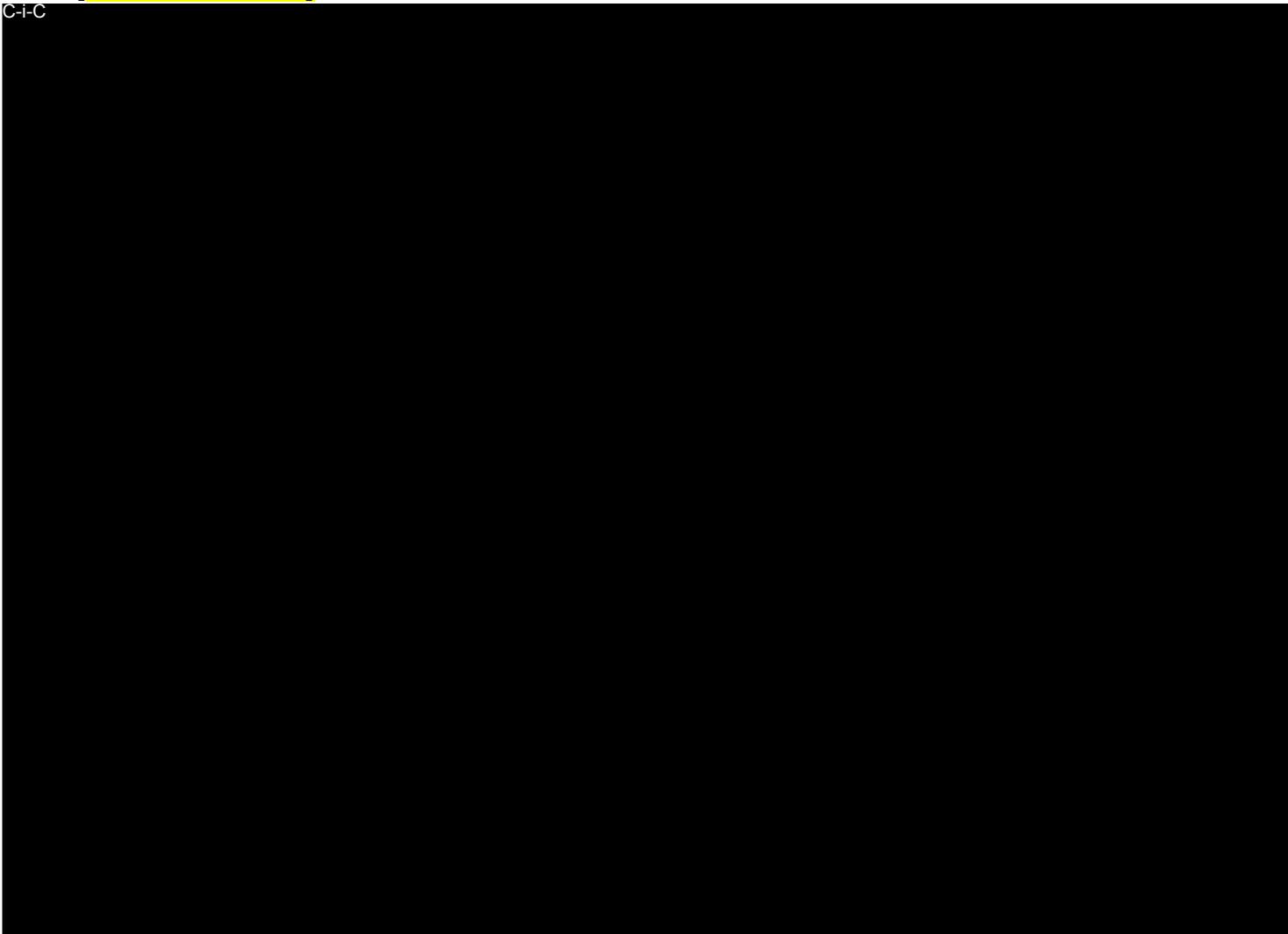
¹⁶ See section 5.7.8 of Telstra's Original Submission.

the very least, any BBM needs to provide sufficient flexibility to respond to variations in demand over time.

Table 4: Telstra's forecast demand for CAN and IEN services

[c-i-c commences]

C-I-C



[c-i-c ends]

* The 2009/10 figures shown in Table 4 above are based on 9 months actual data and three months' forecast data.

143. The forecasts set out in Table 4 were produced by Telstra's Corporate Forecasting Group using the process described in section 5.5.2 of the Original Submission.

144. Although Telstra has not been provided with the time or opportunity to fully explain and justify these forecasts, the accuracy and robustness of these forecasts can be tested, to some degree, by the extent to which they align with those of independent analysts.

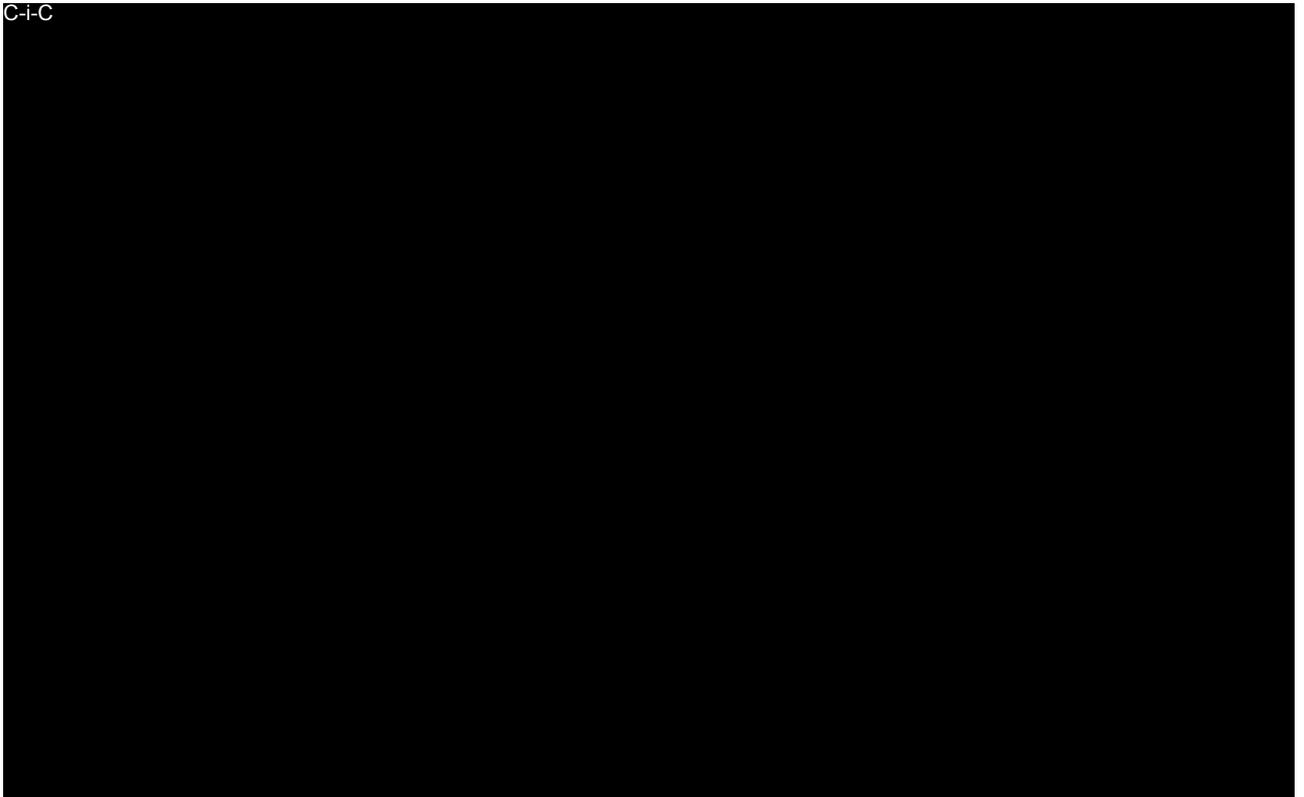
145. In its supplementary submission, Telstra provided the ACCC with data showing the rate of change in the number of fixed lines forecast by Ovum and Business Monitor International

¹⁷ Note that Total CAN services is the sum of ULLS, WLR and Other lines.

("BMI") for the period from 2008/09 to 2014/15. Figure 2 below compares the Ovum and BMI forecasts to Telstra's forecasts for the period from 2010/11 to 2012/13.

Figure 2: Forecast rate of change in number of fixed lines

[c-i-c commences]



[c-i-c ends]

146. As Figure 2 shows, [c-i-c commences] C-I-C



[c-i-c ends] However, BMI's forecast reflects the expected change in the total number of fixed lines across all Australian carriers. BMI has noted that the number of Telstra owned lines may decline at a faster rate, stating:¹⁸

"The available fixed-line data for Australia suggests that Telstra has been losing fixed-line subscribers at a higher rate than the market average."

147. As discussed in Telstra's Original Submission¹⁹, in forecasting demand for CAN and IEN services, Telstra uses a "driver based" process. As part of this process, Telstra analyses historic data to identify the key factors affecting demand and to understand the interdependencies between product groups. Based on this analysis, Telstra develops a set of assumptions about the key factors or "drivers" that are likely to affect future demand. The key drivers considered by Telstra as part of this process include:

¹⁸ Business Monitor International, *Australian Telecommunications Report Q3 2010*, July 2010, page 19.

¹⁹ See section 5.5.2 of Telstra's Original Submission.

- technological change, including the likely rate of fixed to mobile substitution over the forecast period;
- planned network developments/infrastructure roll-outs;
- anticipated changes in the competitive or regulatory environment;
- the commercial and marketing strategies adopted by Telstra and access seekers;
- forecast population and housing growth; and
- forecast economic growth.

148. Of these, Telstra considers that the most significant “driver” of the decline in demand for CAN and IEN services is technological change and, in particular, the impact of new mobile and broadband/IP-based telephony on traditional fixed line services. These factors are discussed in greater detail in schedule 1 to Telstra’s supplementary submission (provided on 11 November 2010).

149. The demand forecasts above (to 2012-13) do not currently include any adjustment for NBN migration. As discussed in Telstra’s Original Submission, the ACCC needs to take NBN migration into account in forecasting demand over the regulatory period. The likely impact of NBN migration can be assessed from public information, including the NBN Implementation Study.²⁰

²⁰ See section 5.5.5 of Telstra’s Original Submission.

11. LSS AND ULLS SPECIFIC COSTS

Q18. The ACCC requests the following information on specific costs to enable it to consider incorporating LSS into the BBM and to separately identify the ULLS specific costs in the BBM:

- **The asset classes in the RAF that include the equipment used to provide the LSS and ULLS specific cost-related services (ie, ordering and provisioning, product management and front-of-house operations) and the value of those assets, or their share of the total asset value for each asset class. The shares of those assets used to provide ULLS, LSS and ADSL internal equivalent services should be specified.**
- **Current and forecast operating and capital expenditures (including indirect expenditures) and relevant to determining the specific costs on an actual cost basis (not TSLRIC basis). The shares of those expenditures relating to ULLS, LSS and ADSL internal equivalent services should be specified.**

150. Telstra's accounts do not separately identify retail xDSL, wholesale xDSL, ULLS and LSS "specific costs" from other types of costs, either for historic capital expenses or forecast capital expenses. Further, it is difficult for Telstra to make the distinction ex-post, because:

- a. The definition of what types of costs make up specific costs is not clear and has been the topic of considerable past debate;²¹
- b. Many costs were capital costs spent in previous years and identifying these would be a substantial exercise that would involve reviewing past invoices and identifying what cost category they were booked against; and
- c. More recent capital expenditures on retail xDSL, wholesale xDSL, ULLS and LSS services are also used for other services, so the distinction between "specific" and other costs has broken down.

151. Therefore, Telstra cannot reasonably identify which RAF asset classes contain cost items related to ULLS and LSS specific costs.

152. However, Telstra suggests that an alternative approach that the ACCC might adopt is to include LSS in the BBM, without relying on identification of unidentifiable "specific" costs. Telstra proposes that the ACCC includes LSS in the BBM by adopting allocation rules for LSS. For example, a cost category in the Ovum BBM could be allocated in part to LSS services on the same basis as allocation occurs for those costs across the other services.

153. This proposed approach is reasonable for the following reasons:

154. First, this approach is consistent with the ACCC's current methodology for determining the "specific cost" component of LSS and ULLS prices, in that the ACCC:

- a. includes indirect operational expenditure (calculated as 20.04% of direct operational expenditure), which are not costs specific to the provision of ULLS and LSS services, but rather an allocation of overheads;

²¹ See, for example: ACCC, *Assessment of Telstra's ULLS and LSS monthly charge undertakings: Final Decision*, December 2005, pp23-29; CORE Research, *The Treatment of ULLS Specific Costs: A Report on behalf of the Australian Competition and Consumer Commission*, May 2006

- b. should include indirect capital expenditure (albeit that the ACCC currently and incorrectly excludes it); and
 - c. pools Retail xDSL, Wholesale xDSL, LSS and ULLS capital costs and divides this aggregate cost pool over demand for those services to determine unit costs.
155. As a consequence, the costs included in the specific cost model (as well as those that *should* be included) are not only specific to individual services, but are also costs related to a group of services including overheads that apply to all services. Because of this, the specific cost model is a complex of different allocation rules for specific and overhead costs.
156. To ensure the allocation rules applied to LSS are consistent with allocation rules applied to other services, and to avoid costs being under or over recovered through the application of different allocation approaches in different models, it would be better to apply consistent rules across all of the relevant fixed service in the one BBM.
157. Second, provided that the allocation rule applied to LSS results in a consistent allocation to retail xDSL, wholesale xDSL and ULLS services also, then this approach would allow the ACCC to implement its "cost pooling" approach in a way that results in all ADSL, ULLS and LSS SIOs making the same contribution to the costs, and ensure overall cost recovery.
158. Third, it would also allow the ACCC to provide an allocation of network costs to LSS, or at least test what impact a network cost allocation would have on LSS prices.
159. Fourth, the current specific cost model makes a broad assumption that retail and wholesale xDSL costs are two times the equivalent costs for ULLS. Given that there is no analysis underlying this assumption, it is likely to be incorrect. Adopting Telstra's proposed approach would mean that the resultant prices are based on actual measures of costs rather than broad and likely incorrect assumptions. This aligns far better with the ACCC's objective of providing for cost-orientation in prices.
160. This approach to cost allocation for LSS is consistent with the approach adopted by Telstra in the RAF accounts. The costs allocated to LSS are reported in the RAF accounts as one service within the broader cost category for "Other External Wholesale Services". In Schedule 10, Telstra has separately extracted the component of costs in the RAF accounts which relate to LSS.

12. REAL ECONOMIC RETURNS

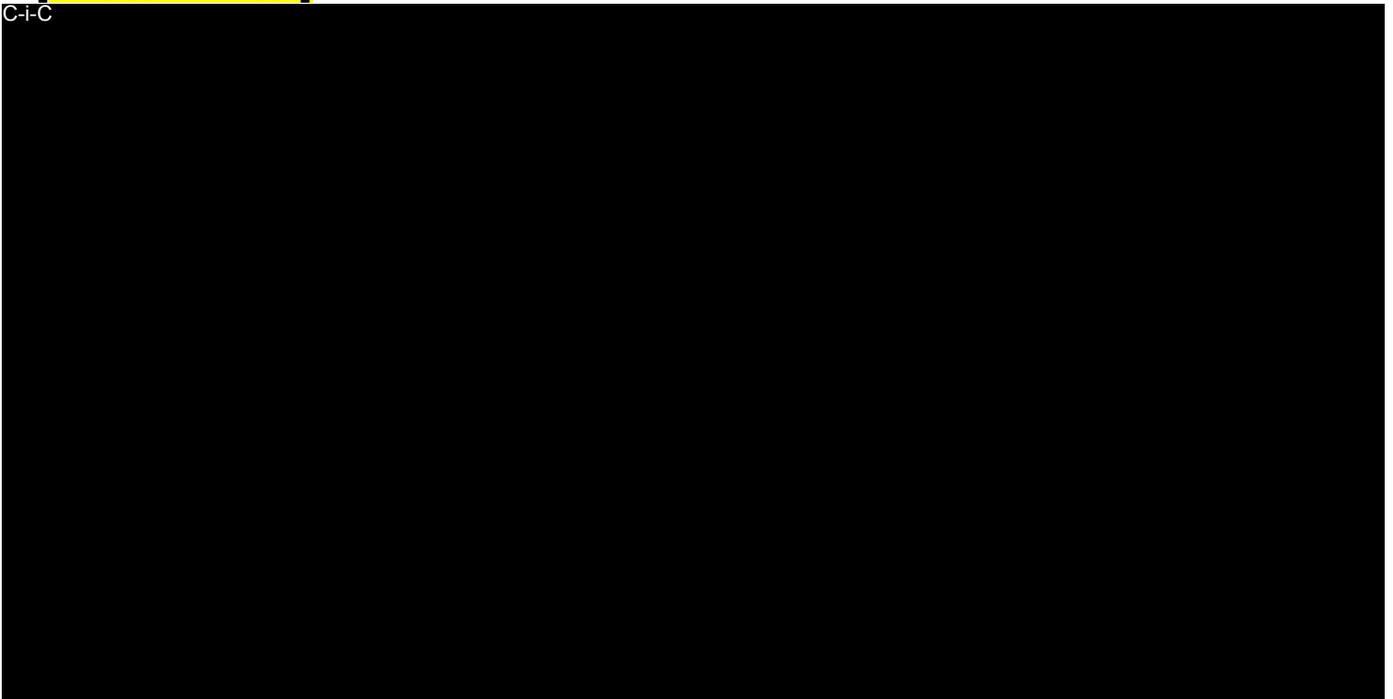
Q19. The ACCC requests that Telstra provide the detailed workings supporting the estimates of its real economic returns, including the source of the data used.

161. The real economic returns reported in page 73 of Telstra's submission were based directly on Telstra's accounting systems. To make these calculations transparent, Telstra has recalculated them so that, where applicable, they are sourced from and linked directly to Telstra's RAF and CCA reports, which Telstra regularly provides to the ACCC.
162. This revised approach will allow the ACCC to verify the calculations and the source. The calculation is set out fully in Schedule 11.
163. The results are slightly different to those presented in page 73 of Telstra's Original Submission, because an additional layer of allocation is undertaken for the RAF and CCA reports to suit the ACCC's preferred reporting structure, which results in different allocations to services. However, the interpretation of the results remains the same. The table below compares the results.

Table 5: Real Economic Returns calculated directly from Telstra's accounts

[c-i-c commences]

C-I-C

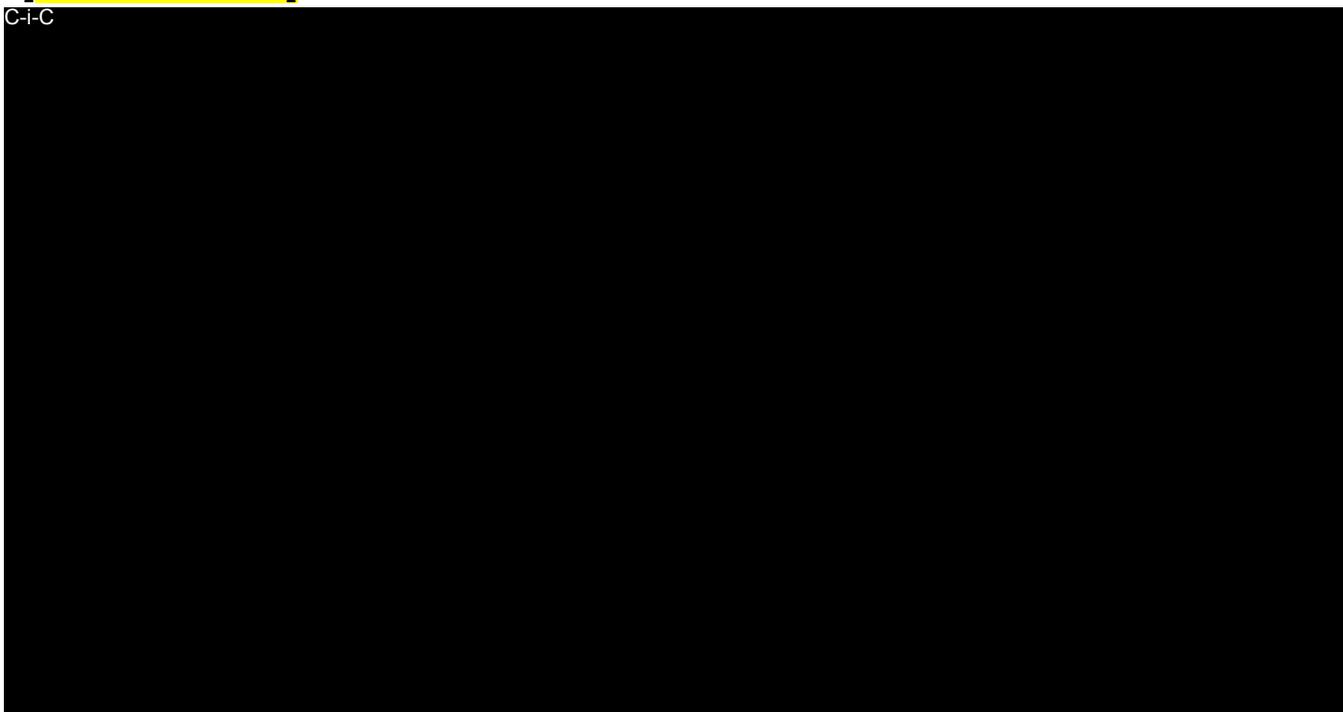


[c-i-c ends]

Table 6: Real Economic Returns calculated directly from Telstra's RAF and CCA

[c-i-c commences]

C-I-C



[c-i-c ends]

Q20. Telstra should also explain why the calculation method for real economic returns (para. 262 of its submission) applies the nominal pre-tax cost of capital to the real value of assets.

164. Telstra applies a pre-tax WACC because the RAF costs do not include tax expenses.

165. There are broadly three consistent ways to apply a nominal or real measure of the cost of capital to a measure of the value of assets²²:

- a. apply a nominal cost of capital to the depreciated historic cost of assets²³;
- b. apply a nominal cost of capital to the current-dollar/real value of assets, and include any revaluation in the income measure; or,
- c. apply a real cost of capital to the current-dollar/real value of assets, but do not include any revaluation in the income measure.

166. Telstra has applied the second approach in the calculation of real economic returns. It has done so because the CCA adjusts the income measures to account for changes in the value of assets.

²² See, for example, Estimating the Cost of Capital for Crown Enterprises and State Owned Enterprises, New Zealand Treasury, October 1997, page 18 in Schedule 12.

²³ This is broadly the approach adopted in the Ovum BBM, but it applies the real cost of capital to the depreciated historic cost of assets and then indexes the results to inflation.

167. The Ovum BBM applies the same approach but in a “round about” way. While it initially applies a real cost of capital to the depreciated historic cost of assets, it then applies inflation to all of the outputs of the model. Multiplying the allocated revenue requirement and the value of assets by inflation means that the Ovum BBM effectively converts the real cost of capital into a nominal cost of capital, adjusts depreciation expenses to account for inflation, and similarly adjusts the asset values by inflation from one year to the next.
168. Aside from the methodology the ACCC has used to value the initial asset base, the Ovum BBM is an indexed historic cost model. That is certainly how capital is treated after 1 July 2009 in the model.²⁴

²⁴ See Professor George Yarrow, *RAB valuation for reformed pricing principles in telecoms*. Submitted by Gilbert + Tobin on 22 October 2010 in response to the ACCC’s Draft Report.

13. RAF SERVICE CATEGORIES

Q21. What is the definition of the 'wholesale end user access' service category in the RAF? Are WLR and LSS included in this service category?

169. Wholesale end user access is defined by the RAF RKR. It is the wholesale equivalent of the internally supplied retail end user access and it does not include either WLR or LSS.

14. SCHEDULES

SCHEDULE NUMBER	TITLE
1.	Network assets that were excluded from Telstra's indexed historic cost calculation (provided in response to Questions 2 and 3)
2.	Network assets that were included in Telstra's indexed historic cost calculation (provided in response to Questions 2 and 3)
3.	Telstra Regulatory Accounting Process – Manual (provided in response to Question 7)
4.	2008-09 and 2009-10 Operating Expenditure – allocated to declared fixed line services (provided in response to Question 7)
5.	Telstra capital expenditure on the CAN and IEN: actual (FY2009-10) and forecasts (FY2010-11) (provided in response to Question 8)
6.	Indirect capital cost values from the RAF (2005-06 to 2009-10) and associated cost factors for depreciated value of indirect capital (provided in response to Question 12)
7.	Factor study in support of factor for indirect capital expenditure (provided in response to Question 13)
8.	Nigel Attenborough report (provided in response to Question 13)
9.	Detailed workings of depreciation calculations (provided in response to Question 15)
10.	Cost allocation for LSS from RAF accounts (provided in response to Question 18)
11.	Telstra worked calculations for Real Economic Return on CAN and IEN assets 2008-2010 (provided in response to Question 19)
12.	Estimating the Cost of Capital for Crown Enterprises and State Owned Enterprises, New Zealand Treasury, 1997 (provided in response to Question 20)