Response to the ACCC Draft Decision on the impact of the NBN for Final Access Determinations for Fixed Line Services

Report for Gilbert + Tobin

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INCENTA
ECONOMIC CONSULTING

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1. Introduction and overview

1.1 Our scope

Incenta Economic Consulting (Incenta) has been engaged by Gilbert + Tobin on behalf of Telstra to review and respond to aspects of the Australian Competition and Consumer Commission's (ACCC) Draft Decision for its public inquiry into final access determinations for fixed line services – primary price terms.[1] I have also been asked to review related elements of the advice provided by its advisor WIK-Consult.

The specific aspects of the Draft Decision that I have been asked to respond to are:

- The treatment of assets in Telstra's fixed line services regulatory asset base (RAB) where a decline in use of those assets is forecast as a consequence of customer migration to the National Broadband Network (NBN), and

- The approach that should be taken to operating expenditure for fixed line services as the previously achieved economies of scale for these services diminishes, also as a consequence of customer migration to the NBN.

1.2 Authorship

This report has been prepared by Jeffrey John Balchin, Managing Director of Incenta Economic Consulting. I have 20 years experience in relation to economic regulation across a range of infrastructure sectors, which has included advising regulators, governments, asset owners and major customers. This has included many years of experience with the design and implementation of the "building block" model of regulation in Australia and New Zealand. My curriculum vitae was attached to an earlier report I provided on this matter.[2]

I have been assisted in preparing this report by Scott Stacey; however, I take responsibility for all of the report's contents.

I have read, understood and complied with the Federal Court's guidelines for expert witnesses.

1.3 Overview of the ACCC's Draft Decision

The matters that are the subject of this report were first raised in the ACCC's Position Paper on the treatment of arrangements between NBN Co and Telstra for regulated pricing that was published in

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1 http://www.accc.gov.au/regulated-infrastructure/communications/fixed-line-services/fixed-line-services-fad-inquiry-2013/draft-decision

2 https://www.accc.gov.au/system/files/Telstra%20Submission%20to%20the%20fixed%20services%20FAD%20primary%20price%20terms%20Discussion%20Paper%20-%20Appendix%202%20%20-%20Gilbert%2BTobin%20expert%20report.PDF

October last year.[3] Following that report the ACCC has published its Draft Decision, which amongst other things, indicate that it proposes to:

- Remove the value of assets that have been sold to the NBN from Telstra's fixed line services RAB as a disposal (with the regulatory value of the asset removed) and, in relation to assets that have been leased to the NBN, take account of NBN's use of those assets when allocating shared costs between fixed line services and other services

- In relation to assets that will be used to a lesser extent as a consequence of customer migration to the NBN:

  – Reduce the value of the RAB associated with copper cables to reflect the proportion of cables that will be decommissioned, and treat the corresponding decrement to the RAB as a deemed "disposal" in the RAB roll forward

  – Reduce the value of the RAB associated with switching equipment assets in line with the fall in use of those assets, and again treat the corresponding decrement to the RAB as a deemed "disposal" in the RAB roll forward, but

  – Retain the RAB value of data equipment in the RAB in full, and

- Make an adjustment (of a form as yet undetermined) to operating expenditure to address what it sees as a loss of economies of scale arising as a consequence of customer migration to the NBN.

1.4 Summary of conclusions

Approach to assets transferred to the NBN

- I agree with the ACCC's proposal in relation to both assets that have been leased to NBN Co and those that have been acquired by NBN Co.

- In relation to the assets that have been acquired by NBN Co, it is appropriate to treat these as a disposal because:

  – There has been a transaction in relation to the assets, and

  – It is clear that the payments in the Definitive Agreements were intended to provide Telstra with an alternative source of cost recovery for these assets, and hence removal of the assets from the RAB is consistent with Telstra being afforded a reasonable opportunity to recover its RAB value.

Approach to assets that are used relatively less due to NBN migration

Not consistent with the Fixed Principles

- I disagree with the ACCC's Draft Decision with respect to those assets that will be decommissioned or utilised to a lesser extent due to customer migration to the NBN. In particular,

3 ACCC, 'Public Inquiry into final access determinations for fixed line services – primary price terms. Position statement on the treatment of the Telstra-NBN Co arrangements for regulated pricing' October 2014.

I consider here the decision to pro-rata down the value of copper cables and switching equipment in proportion to the deemed decline in use and to label the reduction in the asset base a "disposal".

- The ACCC's approach is not consistent with the Fixed Principles. I say this because:
  - There quite clearly has not been a disposal in relation to the assets. The core ingredient for a "disposal" is that there has been a transaction in relation to the assets in question and, as a consequence, an alternative avenue for the recovery of any remaining cost associated with the assets in question.[4]
  - More generally, the adjustment proposed by the ACCC will mean that Telstra will not be provided with a reasonable opportunity to recover its costs (including the value of its RAB), and so is not consistent with the intended outcome of the building block approach.
- I read the Fixed Principles as creating clear requirements as to how the RAB must be rolled-forward from one price review to the next. This is consistent with the ACCC's stated intention to "lock in" an initial RAB value and method of updating in order to provide greater certainty and predictability. The ACCC's proposals in the current matter are antithetical to that intention.
- A motivation for the ACCC's approach is a belief that the payments to Telstra from NBN Co provide an alternative stream of compensation for the assets (and so, absent an adjustment, Telstra will be unfairly advantaged). While I do not believe that this matter is relevant under the Fixed Principles, it is clear to me that the payments were not intended for this purpose in any event (I discuss this issue in more detail below).

Not consistent with encouraging efficient investment

- The ACCC has acknowledged that some level of investment is required for copper cables and switching equipment; however, its proposals will result in new investment (along with existing assets) having no prospect of being recovered, thus providing a strong incentive against the investment. This would be to the detriment of users of the fixed line network.
  - Further, it is naïve to assume that the impact on investment incentives are quarantined to one particular asset type. First, investors will assume that a regulatory compact that applies for the entire framework, in this case the Fixed Principles, has little actual meaning. Secondly, should similar circumstances arise for other assets, for instance if the rollout is advanced or other changes in approach emerge, investors will assume that the ACCC will adopt a similar position in relation to those assets (i.e., to deny a full recovery of cost).

Advice from WIK-Consult is affected by confusion about the requirements of the Fixed Principles

- While WIK-Consult has asserted that it understands the requirements of the regulatory regime, it is clear that its advice assumes the application of the building block approach can be "engineered" to generate a cost that reflects the hypothetical cost of serving the entire market using modern equivalent assets. While there may have been the opportunity to pursue such an objective under

4 I have only ever seen an economic regulator call something a disposal where there has been a transaction and understand that this is also consistent with the use of the term in financial accounting.

the former TSLRIC regime, there is no scope for considering such matters under a building block regime. Indeed, the ACCC's stated purpose for moving to a building block regime was to avoid the need for such hypothesising about efficient cost and the uncertainty and scope for disputation this entails. To the extent the ACCC has relied upon the advice of WIK-Consult in this regard,[5] the ACCC's decision will be in error.

Changing the depreciation profile is the appropriate response to concerns about the time path of prices

- Given different treatment between data equipment (which has a fast return of capital with full cost recovery permitted) and switching equipment (which has a slow return on capital and a proposed write down of the asset value) it is reasonable to assume that the ACCC is most concerned about the alignment between the return of capital and the profile of use for a particular asset. The response to this issue that is most consistent with the building block approach is to adjust the profile of depreciation for copper cables and switching equipment so that it aligns with the profile of usage expected during the transition to the NBN.
  - Making this adjustment to the depreciation profile is reasonably straightforward. All that is required is to forecast the expected decline in asset usage and design a price path such that the full cost can be returned to investors.
- There is no reason for the ACCC to be concerned about the prospect of the 'last user' effectively facing the full cost of the entire network. Real prices are forecast to decline in real terms in the future due to minimal capital expansions and ongoing depreciation. In any event, the ACCC can guarantee that no 'last user' problem arises by setting a price path from today until migration is complete. The price path chosen can be aligned with expected utilisation of the assets such that more costs are recovered in the early years as more customers are connected and less in the later years. If properly designed, the outcome would be relatively stable prices over the entire migration period.

Approach to reduced economies of scale due to the NBN for operating expenditure

- The ACCC – and its adviser, WIK-Consult – bundle together two separate issues, which are:
  - A concern that there is expenditure being incurred and included in regulated fixed line charges that would not have been incurred in the absence of the NBN, and
  - The question of how the loss of economies of scale that result from the demand for fixed line services falling at a faster rate than the decline in operating expenses, should be treated.
- Our report addresses the second of these issues.[6] It is my view there is no discretion on the part of the ACCC as to how this matter is to be addressed. The Fixed Principles permit the ACCC to assess:

[5] The ACCC appeared to give some credence to WIK-Consult's advice in relation to RAB assets in the context of the ACCC's discussion of the loss of economies of scale due in operating expenditure due to NBN migration (see Ibid., p. 141, where all except the third of the points either apply equally to operating and capital expenditure, or apply exclusively to capital expenditure).

[6] I understand that the first issue is being addressed by Telstra in its submission.

  - The prudence and efficiency of forecast (actual) operating and capital expenditure, which requires asking what a firm in Telstra's position (with its regulatory and policy environment and capital assets) would spend, and

  - Whether the demand forecast reflects the expected (actual) demand for Telstra's fixed line services over the period in question.[7]

- To the extent that the combination of the forecasts of prudent expenditure and demand mean that operating expenditure on a per unit basis will increase, then that must flow through mechanistically to the price. To attempt to engineer an outcome that is anything different will mean that Telstra will not have an opportunity to recover its cost, and so be inconsistent with the objective behind the building block approach.[8]

- The ACCC (relying upon WIK-Consult) may be suggesting that Telstra's decision to cooperate (rather than compete) with the NBN was an imprudent decision that is the cause of the loss of economies of scale,[9] and that this historical imprudence would justify a disallowance of expenditure under the Fixed Principles. If this is indeed what is being said, then in my view it is in error.

  - Further, the decision by Telstra to cooperate occurred in an environment where the potential competitor – the Federal Government – had threatened to impose punitive measures on Telstra if it did not cooperate. It would be wrong to conclude this was a choice willingly made.

  - Secondly, in any event, the consequence of the historical choice is that demand for fixed line services may be lower than otherwise – it does not seem to be argued that Telstra's expenditure is higher as a result. However, under the Fixed Principles, while the ACCC may question the prudence and efficiency of expenditure, there is no scope for it to question the prudence and efficiency of demand for fixed line services.

- Again, it is clear that WIK-Consult's advice to the ACCC is heavily coloured by its erroneous view that it is open for the ACCC to engineer the building block approach to generate what it considers would be the outcome of a TSLRIC approach to pricing. Again, if the ACCC's conclusions are based on this view the draft decision similarly will be in error if this advice is followed.

Purpose of payments under the agreement with NBN Co

- I do not agree with the implication by the ACCC in its Draft Decision that the payments received by Telstra from NBN Co provide compensation for Telstra for assets whose use has declined as a consequence of the migration to the NBN. Further, contrary to the view of the ACCC's advisors,

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7 The reference to "actual" expenditure and demand is to distinguish from hypothetical or optimised values for the relevant inputs.

8 The ACCC refers to the "loss of economies of scale" as being incremental to the NBN. This is not a standard use of the economic expression "incremental". Cost (in dollar terms) can be incremental or not, but not average cost.

9 The suggestion that Telstra may have been imprudent to cooperate with the NBN is explicit in WIK-Consult's advice, and seems implicit in the ACCC's statement that charges are higher "as a consequence of the decision by Telstra regarding the future of its copper network" (p. 141).

an outcome where there is no compensation from NBN Co, and none was sought from Telstra, is what should be expected from the context of the agreement.

- I have reviewed a statement by [redacted] together with the public information available at the time. Based upon this evidence, it is clear that the payments between NBN Co and Telstra were for:
  - Infrastructure access payments which provide for large scale access by NBN for certain infrastructure including dark fibre, exchange space, and ducts
  - Infrastructure ownership payments which provide for the transfer of ownership to NBN Co of various infrastructure assets that are linked to progress of the NBN rollout, and
  - Disconnection payments, which are progressive payments principally linked to the number of premises disconnected and provide partial compensation for the loss of an ongoing business after the roll-out of the NBN.
- Most notably, Telstra's computation of the loss under different NBN scenarios, and its financial accounting since then, has never counted upon the loss of value of the fixed line assets in the period prior to the roll-out of the NBN.
- Given the Fixed Principles were developed at the same time as the Definitive Agreement these would have been taken into account in negotiations between NBN Co and Telstra. The requirement for an expectation of full cost recovery under the Fixed Principles means that neither party would have expected that there was a stranded asset risk and a need for compensation. Indeed, it would not make commercial sense for NBN Co to have paid any amount for asset stranding compensation given the requirements of the Fixed Principles.

1.5 Structure of this report

The remainder of this report is structured as follows:

- Chapter 2 addresses the ACCC's Draft Decision with respect to Telstra assets that are transferred or leased to the NBN
- Chapter 3 focuses on the proposed approach for assets that are used relatively less due to the migration of customers to the NBN
- Chapter 4 focuses on the ACCC's Draft Decision to make an adjustment to operating expenditure allowances to account for declining demand, and
- In Chapter 5 I set out my understanding of the purpose of the payments made by NBN Co to Telstra.

2. Approach to assets transferred to the NBN

2.1 Introduction

The NBN will replace Telstra's fixed line network as the infrastructure to provide fixed line telecommunications services in Australia. The current Government's approach to the NBN means that NBN Co will lease and acquire certain infrastructure from Telstra that is currently used to provide fixed line services. The issue that arises in the context of Telstra assets that are leased or acquired by NBN Co is what should be the consequences of these transactions for the calculation of prices for Telstra's fixed line services.

2.2 Summary of ACCC Draft Decision

The ACCC's Draft Decision with respect to Telstra assets that are either leased to, or acquired by, NBN Co is to make the following adjustments:

- Assets that are leased to NBN Co will remain in Telstra's RAB; however, NBN Co's use of those assets will be taken into account when allocating the cost associated with shared assets between Telstra's regulated fixed line services and other uses of those assets.[10]

- Assets that are to be transferred from Telstra to NBN Co will be treated as a "disposal" and removed from the RAB. The specific value that will be removed from the RAB is proposed to be the value ascribed to the assets in question in the RAB (their "regulatory value").[11]

2.3 Response to ACCC Draft Decision

With respect to assets that are to be leased to NBN Co, NBN Co will be one of a number of users of the assets in question. I agree that the fixed principles clearly contemplate that NBN Co's use of these shared assets should be taken into account when deciding how much of the cost to allocate to the regulated fixed line services. I therefore agree with the ACCC's decision in this regard.

In relation to the assets that are to be sold to NBN Co, I also agree with the ACCC's decision to treat these assets as having been subject to a disposal and removed from the RAB. I say this because there has been a transaction in relation to the assets in question, and a change in the ownership and control of the assets, and a consequent flow of consideration to Telstra.

As I have noted in my earlier reports, Section 6.7 of the Fixed Principles require that the RAB value only be adjusted either for capital expenditure, depreciation or disposals. Within the context of the application of the building block approach, the objective is to ensure that the process of updating the RAB over time is consistent with Telstra being provided with a reasonable opportunity to recover its costs, including the starting value of its RAB. This implies that any downward adjustment to the RAB needs to be accompanied by a source of revenue. Applying this to the formula in the Fixed Principles:

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10 ACCC, 'Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision', March 2015, p. 138.

11 ACCC, 'Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision', March 2015, p. 136.

- It is appropriate to remove *depreciation* from the RAB to the extent that this has been allowed for in setting regulated prices, and

- It is appropriate to treat assets as having been *disposed* of where there has been a transaction in relation to the assets and that transaction has generated an alternative source of cost recovery for the asset in question.

I note more generally that it was clear that the payments in the Definitive Agreements were intended to provide Telstra with an alternative source of cost recovery for these assets. Accordingly, removing these assets from the RAB is consistent with Telstra being afforded a reasonable opportunity to recover its RAB value.[12]

Lastly, I note that there has been a debate about the quantum of adjustment that should be made to Telstra's RAB in respect of the disposed assets. I agree with the ACCC's decision to remove an amount that reflects the regulatory value of the assets disposed. This is because:

- It is consistent with the more meaningful of the regulatory precedents (namely, the cases where the assets are going to remain in use but are just being transferred from one owner to another)

- It ensures a consistent treatment between the leased and sold assets (the costs allocated to NBN Co's use of the leased assets will reflect the regulatory value of those assets), and

- It is consistent with ignoring the financial transaction between NBN Co and Telstra to the greatest extent possible, which has been a hallmark of the practice of incentive regulation in Australia to date.

12 See, for example: Telstra, 'Explanatory Memorandum, for the resolution under item 2 at the Annual General Meeting on 18 October 2011: Telstra's Participation in the Rollout of the National Broadband Network', p. 28, which identifies that Telstra will receive payments for providing NBN Co with access to certain parts of Telstra's infrastructure.

3. Approach to assets that are used relatively less due to NBN migration

3.1 Introduction

One of the consequences of the requirement that customers be migrated over to the NBN is that it forces a decline in demand for the relevant fixed line services that cannot be reversed. This means that some of Telstra's fixed line assets will be used less than would otherwise have been the case.

3.2 Summary of ACCC Draft Decision

Building upon the views expressed in its recent Position Paper, the ACCC's Draft Decision is that account should be taken for the fact that customer migration to the NBN will mean that some assets that are currently used to provide declared services will no longer be used for that purpose, either fully or in part.[13]

The ACCC considers that copper cables, specifically those in FTTP and HFC areas where they will not form part of the NBN, will progressively be decommissioned as customers are migrated to the NBN. The ACCC's draft decision is that because these assets will no longer be used to provide the fixed line services, that they should be removed from the RAB, with the resulting deduction from the RAB to be treated as a disposal.

With respect to assets that are still required to provide fixed line services, but are utilised to a lesser extent due to NBN migration, the ACCC has focused on two assets types, namely:

- Data equipment, and
- Switching equipment.

The ACCC's Draft Decision is that while both of these asset types will experience a decline in demand due to migration to the NBN, only the costs associated with data equipment can continue to be recovered in full.[14] For switching equipment, the ACCC considers that adjustments are required to reflect the resulting reduction in utilisation. Specifically, the ACCC intends to pro-rata down the value of the assets in proportion to the deemed decline in demand and label the reduction in the asset base as a "disposal".[15]

The ACCC's stated reason for allowing the recovery of data equipment in full is that the profile for the return of capital aligns with the expected use of the asset. The ACCC also identifies that given per

[13] ACCC, 'Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision', March 2015, p. 139.

[14] ACCC, 'Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision', March 2015, p. 139.

[15] ACCC, 'Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision', March 2015, p. 140.

SIO traffic is growing it is necessary to provide incentives for ongoing investment for this asset category.[16]

> *In the case of data equipment, the ACCC's draft decision is that adjustments to account for any under-utilisation of these assets are not required. Data equipment has a short asset life (six years for new assets) and capital expenditure on data equipment is forecast to decline sharply. The combined effect of these two factors is that the data equipment RAB is forecast to fall sharply over the regulatory period, such that the forecast pace of decline in the regulatory value of data equipment aligns closely with that of total ADSL SIOs. The ACCC considers that this alignment does not support an argument that data equipment should be adjusted to reflect potential under-utilisation.*
>
> *Further, despite the shrinking of Telstra's fixed line network, per SIO data traffic is an area of growth. The ACCC considers that it is appropriate to provide incentives for efficient investment in and operation of the legacy data network, particularly during the transition to the NBN.*

In the case of switching equipment, the ACCC notes that this asset category has a relatively long asset life that extends beyond the time when the assets are expected to be used. As such, the ACCC indicates that the pace of decline in the RAB for these assets is slow. It also notes a minor capital expenditure requirement for these assets.

The ACCC's advisor, WIK-Consult, was also of the view that assets that are utilised to a lesser extent should be removed from the asset base, stating:[17]

> *Also the impact of customer migration from Telstra's fixed line network to the NBN should be taken into consideration. Affected assets should either be decommissioned or if utilised to a lesser extent partially be removed from the regulated cost base.*

A number of arguments appear to have been put forward by WIK-Consult for this position. These include that it is consistent with the ACCC's Position Paper and that access seekers have no influence on the speed of migration and therefore should not pay for diseconomies of scale. I address the role of Telstra on the migration of customers to the NBN in chapter 4. However, another key argument from WIK-Consult appears to be that Telstra's 'diseconomies of scale' argument is flawed because it does not take into account advancements in technologies and the costs associated with Modern Equivalent Assets (MEA):[18]

> *9.3.5 No misinterpretation of diseconomies of scale*
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> *371. Telstra's basic argument for requiring an increase of wholesale rates for FLS are diseconomies of scale: Telstra claims that regulated FLS are provided in legacy network components (copper cable), and that shrinking demand for FLS (regulated wholesale plus*

16 ACCC, 'Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision', March 2015, pp. 139-140.

17 WIK-Consult, 'Assessment on the efficiency and prudency of Telstra's expenditure forecasts', 5 March 2015, p. 25.

18 WIK-Consult, 'Assessment on the efficiency and prudency of Telstra's expenditure forecasts', 5 March 2015, pp. 124 -126.

non-regulated retail) caused higher average costs per unit of output (see Figure 9-3-1). Though plausible at first glance, the "diseconomies of scale"-argument is flawed.

[figure omitted]

372. The first flaw is the presumption that the cost curve – i.e. the functional relationship between costs and service volumes – does not change in the course of time. In reality, however, the cost curve does change. The cost curve in 2018 will not be the same as the cost curve in 2014 (see Figure 9-3-2). That change of the cost curve is determined by technical progress. In this context, it is important to note that the shape of Telstra's economic cost curve does not depend on the technology that Telstra deploys in reality. In fact, that cost curve is independent from the vintage of the assets deployed. To determine the cost curve, the costs associated with Modern Equivalent Assets (MEA) have to be analysed. Claiming that legacy networks in 2018 would be associated with higher costs than the MEA just indicates the book value attributed to legacy assets is higher than the economic value of the legacy assets.

[figure omitted]

373. The second flaw of the "diseconomies of scale"-argument is that relevant service volumes are defined on the basis of distinct technology: Telstra interprets FLS as services provided on its legacy networks. However, it is not technology that defines relevant service volumes, but the substitutability of services according to the SSNIP-test. The substitutes for FLS that can be provided on NGN/NGA have to be taken into consideration when determining the average economic costs per unit of output (see Figure 9-3-3).

[figure omitted]

9.3.6 The impact of denied price increases

374. In the subsections above it has been demonstrated that the average economic costs of providing FLS and its substitutes are declining in the course of time. At this background it can be concluded that keeping rates for regulated FLS constant would not do economic harm to Telstra. This means: If the ACCC denied an increase of rates for regulated FLS, it would not affect Telstra's investment decisions, while Telstra would still enjoy a positive producer surplus.

3.3 Response to ACCC Draft Decision

3.3.1 Fixed Principles do not permit the ACCC approach

ACCC's proposal is not consistent with the Fixed Principles

In my view, the ACCC's proposal to remove a value associated with decommissioned copper cables and part of the value of the switching assets from the RAB to reflect the declining use of these assets during the migration to the NBN is not permitted by the Fixed Principles. I say this because:

- There has not been a transaction in relation to these assets, and

- As a consequence there is no alternative route for cost recovery provided in relation to these assets.

In relation to the ACCC's view that it can treat the assets in question as a disposal, I have only ever seen an economic regulator call something a "disposal" where there has been a transaction involved, which I understand is also consistent with the use of the term in financial accounting. As I explained in the previous section, from an economic perspective, the presence of a transaction is essential: as I said, it is only permissible to reduce the value of the RAB where this is matched with a flow of revenue, either from customers of the service (i.e., depreciation that is factored into prices) or from an external party (i.e., as a disposal). The absence of a transaction in the current context means that there is no alternative avenue for the recovery of any remaining cost associated with the asset in question. Consequently, Telstra would not be provided with an opportunity to recover its costs (including its RAB) under the ACCC's draft decision.

I observe that Clause 6.7 of the Fixed Principles sets out a mechanistic approach for updating the RAB. I read these provisions as creating clear requirements as to how the RAB must be rolled-forward from one price review to the next. It is notable that the ACCC introduced this approach on the basis that it improves certainty by locking in the initial value of the assets and then rolling this forward by actual changes in the value of the asset base:[19]

> *During that FAD inquiry, the ACCC considered that a BBM would improve certainty by 'locking in' the initial value of the regulated assets, which would then be rolled forward by actual changes in the value of the asset base. The ACCC considered that this certainty would promote efficient use of and investment in infrastructure through greater predictability in revenue and price paths. Further, the ACCC considered that determining prices through a transparent and cost based pricing model will provide regulatory certainty for both access provider and access seeker about the way the ACCC would set prices, and that such certainty would promote efficient investment and competition in the markets for carriage services.*

The ACCC's proposals with respect to both decommissioned assets and assets used to a lesser extent are antithetical to the stated intention of the application of the building block approach and also the mechanistic roll-forward method.

In making its Draft Decision on assets that are impacted by the migration of customers to the NBN the ACCC cites the payments made between NBN Co and Telstra. The ACCC's discussion of this agreement seems to suggest that these payments were also intended to compensate Telstra for the prospect that the ACCC may seek to remove these assets from the RAB, and so if the ACCC does not now make an adjustment then Telstra will be unfairly advantaged. I note that the intention of these payments is not relevant – the Fixed Principles only permit the RAB to be reduced for a disposal, and as there has been no transaction in relation to the assets, there has not been a disposal. However, I address the merits of the ACCC's suspicion about the intention of these payments in Chapter 5 below, where I conclude that it is clear to me that the payments were not intended to compensate Telstra for the prospect of the ACCC seeking to remove the assets in question from Telstra's RAB, and so the basis for the ACCC's concern that Telstra may be unfairly advantaged falls away.

[19] ACCC, 'Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision', March 2015, pp. 136-137.

Advice from WIK-Consult is affected by confusion about the requirements of the Fixed Principles

The ACCC's advisor, WIK-Consult, asserts that its analysis is framed on the basis of the building block approach.[20] It is clear, however, that its advice assumes the application of the building block approach can be "engineered" to generate a cost that reflects the hypothetical cost of serving the entire market using modern equivalent assets.

In the paragraphs that were cited earlier from the WIK-Consult report, the reasoning for rejecting any argument that per unit rates may need to increase were that it was open to the ACCC to determine unit costs:

- with reference to the unit cost associated with modern equivalent technologies, and
- with the costs assumed to be spread over the whole of the fixed line service "market", where demand therefore includes all demand for potentially substitute services (i.e., determined using a "SSNIP" test") irrespective of whether those customers are served using Telstra's assets or by someone else (such as NBN Co).

However, the ACCC is required to apply the Fixed Principles, and under these principles:[21]

- there is no ability to set prices with reference to the hypothetical cost of service using "modern equivalent assets", rather the ACCC is required to set prices that provide a reasonable return on (and of) the RAB value and to allow for a recovery of prudent and efficient (actual) operating expenditure (this issue is returned to in Chapter 4), and
- the volumes that are used to convert required revenues into prices are required to reflect the volume of sales by Telstra – there is no ability to apply instead hypothetical whole of market volumes (and, as such, no scope or relevance for the use of the SSNIP-test).

It is noted that under the former TSLRIC approach, prices were determined with reference to the use of hypothetical modern technologies, and under this approach the capacity existed to assume a hypothetical supply of the whole of the market. However, since then the regulatory regime (and the tools and mechanisms available thereunder) has changed fundamentally, with the ability to "free form" – and the resulting scope for uncertainty and disputation – being given away for the greater certainty and predictability of the building block approach. Within this new framework, the objective against which WIK-Consult assessed Telstra's arguments has no relevance.

It is not clear from the ACCC's decision about the extent to which it endorsed WIK-Consult's reasoning on these matters. The ACCC's suggestion that it can "optimise down" the RAB suggests that it has endorsed at least part of WIK-Consult's reasoning, and the ACCC's Draft Decision also

20 WIK-Consult, 'Assessment on the efficiency and prudency of Telstra's expenditure forecasts', 5 March 2015, p. 13.

21 The arguments from WIK-Consult are also subject to other challenges. For example, WIK-Consult's reasoning cited in the text was about the expected change in unit cost of using a hypothetical optimal network over the course of the next pricing period. For this to have any relevance to Telstra's prices, it would need to have been the case that Telstra's current prices were set with reference to the (full) cost of a hypothetical optimal network. However, this was clearly false. Telstra's opening RAB was set well below the then estimates of the cost of a hypothetical optimal network.

gives the appearance of endorsing WIK-Consult's perspective when considering the impact of diseconomies of scale.[22] In my view, to the extent the ACCC seeks to rely upon the advice of WIK-Consult in this context, the ACCC's decision will be in error for the reasons set out above.

3.3.2 ACCC approach does not promote efficient investment

In its Draft Decision the ACCC acknowledges that some level of investment is required for copper cables and switching equipment. However, the ACCC's proposals for these assets will mean that there is no prospect of the costs associated with new investment (along with existing assets) being recovered. The fact that the ACCC's approach will mean that the full costs of supply cannot be recovered means that the incentive for Telstra is to avoid this investment to the extent it is possible to do so. Minimising capital expenditure can be efficient. However, this is not the case when it is done at the expense of expenditure that the ACCC itself deems to be necessary. The only outcome in this case is reduced service quality and performance outcomes for customers.

It is also my view that it is would be naïve to assume that a decision that does not permit full cost recovery on one asset type will not have implications for investment incentives for other assets. In the first instance, investors will assume that the regulatory compact between the regulator and the regulated business, in this case the Fixed Principles, has little meaning. In the second instance, investors will assume that should similar circumstances arise for other assets, that is, declining demand where the return on capital is slow, the assets will become stranded with no compensation. This could occur, for instance, if there was a circumstance that caused the migration to occur faster than was first assumed. Either of these outcomes substantially increased the perceived level of regulatory risk of a regulatory framework. Therefore, it is important the ACCC be cognisant that its decision to prevent cost recovery for one type of asset will have an impact over the incentives to invest over a broader range of assets than the one that is the target for the ACCC in this price review decision.

3.3.3 Achieving alignment between capital returns and utilisation under the building block approach

Alignment between usage profile and return of capital

The ACCC has taken different approach to two assets that will be used to a lesser extent due to the migration to the NBN. The key justification for the different approaches appears to be that for one asset type, data equipment, the return of capital is fast and therefore aligns better with the expected profile of use. Conversely, for the other asset type, switching equipment, the return is expected to be slow and extend past the forecast profile of use for that asset type. This rationale for different approaches suggests that the ACCC is most concerned about the alignment between the return of capital and the profile of use for that particular asset.

There are two obvious responses to the ACCC's concern.[23] The response that is most consistent with the building block approach is to adjust the profile of depreciation for copper cables and switching equipment so that it aligns with the profile of usage expected during the transition to the NBN. For copper cables this means increasing the rate of depreciation so that the value of the RAB is returned

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22 This discussion of diseconomies of scale is contained in section 9.5.3 of the Draft Decision.

23 I note, for the avoidance of doubt, that there is no necessity for the profile of use to be aligned with the return of capital. What is required above all else is that the capital be returned to investors sufficiently quickly so that they can expect to have all the value of the investment returned.

prior to decommissioning. For assets that are used to a lesser extent this would be achieved by increasing the rate of depreciation for these assets so that less in total remains to be recovered in future years when utilisation has fallen. This would then align the approach taken to switching equipment to the ACCC's proposed approach to data equipment. All that is required in order to implement this approach is to forecast the expected decline in asset usage and design a price path such that full costs can be returned to investors.

The need for the approach to regulatory depreciation to keep pace with economic depreciation was made by the Victorian Office of the Regulator General (ORG) in one of the first applications of the building block approach to incentive regulation in Australia. Specifically the ORG stated:[24]

> *The regulatory asset base represents the regulator's view of the market value of the regulated business at any point in time. Accordingly, the regulator can be interpreted as making an implicit commitment to ensure that the market value of those assets does not fall below the regulatory asset base over time. The objectives of encouraging efficient investment will only be met if this remains a credible commitment.*
>
> *This has important implications for the design of the regulatory depreciation profile. In particular, in order to ensure that the regulatory asset base remains at or below the market value of the assets, the regulatory regime must permit each distribution licensee to have their capital returned at a rate that keeps pace with the decline in the economic value of their assets. This in turn implies that regulatory depreciation must at least keep pace with economic depreciation. This will ensure that the value of the distribution licensee should not be placed in a position in the future where it is not able to set tariffs that are expected to recover the benchmark revenue requirement.*

The alternative response to an adjustment to depreciation is to provide separate compensation for the risks associated with asset stranding. I note that such compensation has not already been provided to Telstra for these risks. Therefore, should the ACCC continue with its proposed approach it is not possible for Telstra to recover the full costs of supply.

I note that in the past the ACCC has accepted that the approach to depreciation can be used to ensure that capital is returned to investors sufficiently quickly so that an expectation of full cost recovery can be maintained.[25] In the ACCC's 2000 decision on Telstra's PSTN undertaking the ACCC recognised that stranded asset risk existed and needed to be taken into account in setting prices. In this case the ACCC considered three options, being an adjustment to the asset/equity beta, a cash flow allowance, or an adjustment to the depreciation profile. The ACCC decided to take account of the stranded asset risk through an approach referred to as a 'tilted annuity'. In effect, the tilted annuity approach

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24 ORG, '2001 Electricity Distribution Price Review, Cost of Capital Financing, Consultation Paper No. 4', May 1999, p. 15.

25 The ACCC appeared to state in the draft decision that it would be prepared to permit the life of copper cables to be shortened to match the roll out of the NBN in order to permit Telstra to recover its costs (p.128), which is consistent with what we advocate. However, if the ACCC intends to alter the lives in this manner, then it is not clear why it considers there to be a need for decommissioned copper cables to be removed from the RAB – if the correct lives have been applied, then there should be nothing to remove. In addition, for other assets – including switching equipment – the ACCC rejected Telstra's proposed shortening of asset lives, which is the opposite of what consider should be done (to be clear, we advocate an advancement of the recovery of capital, shortening lives is one means of giving effect to this).

front-ended the return of capital to Telstra. When making this decision the ACCC stated the following:[26]

> *In terms of stranded asset risks, the Commission accepts that, in the case of the PSTN, there could be a risk that technological advances could make assets redundant such that they lose their resale value. The Commission considers, however, that it has taken account of this risk through its approach to modelling cash flows because the Commission has tilted the annuity to take account of changes in the replacement cost of assets used to provide the PSTN. This approach is outlined in more detail in Appendix 5.*

The ACCC then describes the objective of its 'tilted annuity' approach as follows:[27]

> *By tilting the annuity costs can be recovered earlier than if a simple annuity approach is used. The Commission acknowledges that in telecommunications one might expect technological advances to reduce the future replacement cost of some assets. The use of a tilted annuity means that it is unlikely that Telstra would suffer from the depreciation being back loaded or 'being lost through re-optimising. With a tilted annuity approach in this situation it is very likely that capital costs will be recovered early in their life.*

There is no 'last user' problem

Another concern that may be driving the ACCC's proposed approach is a view that the 'last user' connected to the network will effectively face the full cost of the entire network. It is my view that this is not a genuine concern and should not influence the ACCC's approach.

Rather than prices increasing exponentially as customers migrate to the NBN, the facts are that real prices are forecast to decline in real terms into the future. The reason for this is straightforward. First, capital expenditure is rapidly declining, such that there are limited additions to the RAB to cause an increase in prices. Secondly, depreciation of the asset base also means that the RAB declines over the relevant period.

In addition to this, I note that to the extent that any concern remains, the ACCC can deliver full cost recovery but also guarantee that no 'last user' problem arises. This can be achieved by setting a price path from today until the migration is complete. The price path chosen can be aligned with expected utilisation of the assets such that more costs are recovered in the early years as more customers are connected and less in the later years. If properly designed, the outcome would be relatively stable prices over the entire migration period.

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26 ACCC, 'A report on the assessment of Telstra's undertaking for the Domestic PSTN Originating and Terminating Access services', July 2000, p. 91.

27 ACCC, 'A report on the assessment of Telstra's undertaking for the Domestic PSTN Originating and Terminating Access services', July 2000, p.97.

4. Approach to reduced economies of scale due to the NBN for operating expenditure

4.1 Introduction

An issue that was not raised explicitly in the ACCC's Position Paper but has been raised in the Draft Decision relates to the impact of declining demand on per unit operating expenditure costs, or as the ACCC refers to it, reduced economies of scale.

4.2 Summary of ACCC Draft Decision

The advice by WIK-Consult – which the ACCC adopted – was that access seekers should not be charged for any expenditure or cost that is caused by the migration to the NBN. WIK-Consult's reasoning in relation to capital expenditure matters (and discussed above) was applied also to operating expenditure.[28]

> *294. Access seekers should not pay for any diseconomies of scale resulting from the migration of customers from Telstra to NBN Co. Telstra takes a different view and argues that FLS access seekers should be attributed a share of the expenses for the remediation of duct and other NBN-related expenses. This view implies that the NBN roll-out is an economic burden on Telstra. That thesis can be challenged on the grounds of the Forecast Model. Irrespective of these considerations, there must be no doubt that FLS access seekers must not be charged for any cost directly or indirectly caused by the NBN roll-out. That principle prevails no matter whether or not the deal between Telstra and NBN Co is economically advantageous for Telstra.*

And:[29]

> *292. FLS access seekers must not be charged for any expenditure or cost that is caused by the migration of customers to the NBN. Those expenditure and cost should be regarded as incremental to the NBN. This implies:*
>
> > *a) FLS access seekers must not be charged for any CAPEX that is associated with the lease or sale of resources to NBN Co.*
> >
> > *b) FLS access seekers must not be charged for the disposal of DSLAM or other plant that gets redundant for no other reason but the migration of customers to the NBN.*
> >
> > *c) FLS access seekers must not be charged for any increase of OPEX associated with the maintenance of ducts or copper cable that is caused by the roll-out of fibre by NBN Co.*
> >
> > *d) The amount of duct and cable costs attributed on average to a CAN SIO must not increase as the number of active wire pairs declines in the course of NBN roll-out*

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28 WIK-Consult, 'Assessment on the efficiency and prudency of Telstra's expenditure forecasts', 5 March 2015, p.95.

29 WIK-Consult, 'Assessment on the efficiency and prudency of Telstra's expenditure forecasts', 5 March 2015, p.94.

(that is to say, FLS access seekers must not be charged for diseconomies of density caused by the NBN roll-out).

e) FLS access seekers must not be charged for floorspace that gets redundant as MDF can be removed when the NBN roll-out is completed in a region of migration.

f) FLS access seekers must not be charged for the commissioning of assets and asset life extension (Telstra-terminology: PROPEX) of NBN-related equipment.

The ACCC agreed with WIK-Consult and stated that access seekers should not incur higher charges for fixed line services as a consequence of the decision by Telstra regarding the future of its copper network. It states that it is still considering this issue and how it will identify the increase in unit operating costs due to NBN-induced loss of economies of scale and diversity.[30]

4.3 Response to ACCC Draft Decision

The advice of WIK-Consult – upon which the ACCC has relied – bundles together two separate issues, which are:

- A concern that there is expenditure being incurred and included in regulated fixed line charges that would not have been incurred in the absence of the NBN, and
- The question of how the loss of economies of scale that result from the demand for fixed line services falling at a faster rate than the decline in operating expenses, should be treated.

Our report addresses the second of these issues identified above. I understand that Telstra will address the first of the issues noted above in its submission.

In relation to the relevance of the loss of economies of scale for regulated fixed line charges, again this is an issue upon which, in my view, the ACCC does not have the discretion to do what WIK-Consult advocates and the ACCC proposes.

Clause 6.8(c) of the Fixed Principles requires that the revenue requirement comprise operating expenditure forecast to be incurred in that regulatory year. Clause 6.9 requires that under the building block approach forecast operating expenditures should reflect prudent and efficient costs. The sub-clauses then set out the matters relevant to whether forecast operating expenditure reflects prudent and efficient costs, namely:

(a) *the access provider's level of operating expenditure in the previous regulatory period;*

(b) *reasons for proposed changes to operating expenditure from one regulatory period to the next regulatory period;*

(c) *any relevant regulatory obligations, or changes to such obligations, applicable to providing the relevant declared fixed line services; and*

30 ACCC, 'Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision', March 2015, pp. 140-141.

> *(d) any other matters relevant to whether forecast operating expenditures reflect prudent and efficient costs.*

Further to this, clause 6.11 sets out the requirements for demand forecasts. In summary, the requirements relate to the use of an appropriate forecast method, the use of reasonable assumptions of key demand drivers, utilisation of the best available information, and to take into account current demand and economic conditions.

Thus, the Fixed Principles permit the ACCC to consider the prudence and efficiency of operating expenditure and whether the demand forecasts reflect expected (actual) demand. Assessments of the prudence and efficiency of expenditure occur in some form within all sectors that are subject to a building block approach to regulation, and there is a substantial degree of clarity as to what such an assessment entails. Indeed, there has been much written on this topic in the context of the energy sector.[31] It is clear from the application by other regulators, and the decisions of the Australian Competition Tribunal, that the focus is on what someone in Telstra's position, facing its regulatory and policy environment and with its stock of capital assets, would spend. The Tribunal made its position clear that an assessment of the prudence and efficiency of expenditure must be done by having regard to the particular circumstance of the business when deciding upon an appeal against a decision of the Australian Energy Regulator (AER) in relation to Ergon Energy, as follows:[32]

> *There is substance to the concerns underpinning the AER's submission that to automatically allow a labour cost increment negotiated under an agreement that transits two regulatory periods creates an unacceptable risk of undermining the incentives to promote economic efficiency in future negotiations for such an agreement. The concerns are not, however, sufficient to conversely and automatically reject a labour cost increment so derived. Indeed, the gravamen of Ergon Energy's complaint, namely, that the AER had failed to satisfy itself in terms of cl 6.5.6(c) by investigating whether the circumstances in which the UCA had been negotiated resulted in efficient costs, costs that a prudent operator in Ergon Energy's circumstance would require and costs which founded a realistic expectation of the cost inputs required to achieve the opex objectives, is well founded. The AER's reliance on the forecasts of its consultant, Access Economics, to arrive at its real escalator for the first year of the regulatory period, is no substitute for such an investigation.*
>
> …
>
> *the Tribunal is satisfied that not investigating the circumstances in which the UCA had been negotiated but rather relying on its consultant's figure to arrive at its real escalator for the first year of the regulatory period was an error of material fact on the part of the AER and an incorrect exercise of the discretion available to it in satisfying itself in terms of cl 6.5.6(c) of the Rules.*

Similarly, in relation to the forecast of demand, there is less discretion – the objective is to derive the best forecast of actual quantities of the relevant services over the period.

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31 See, for example: http://www.aemc.gov.au/Rule-Changes/Economic-Regulation-of-Network-Service-Providers

32 Australian Competition Tribunal, 'Application by Ergon Energy Corporation Limited (Labour Cost Escalators) (No 3) [2010] ACompT 11, paras. 57-58.

Therefore, if given the forecast of prudent and efficient operating expenses and demand the per unit cost will increase, then the only outcome that is permitted by the Fixed Principles is that the increase in per unit cost be permitted to flow through into prices. There is no scope for the ACCC to deny the change in prices and the correct response to the increase in per unit operating costs that is caused by a decline in demand is for these to be reflected in full in prices. To attempt to "engineer" an outcome that is anything different will mean that Telstra will not have an opportunity to recover its costs, and so be inconsistent with the objective behind the building block approach. Indeed, it is worth noting that if fixed line services were regulated for the first time today, there is no question that a full recovery of operating costs would be allowed.

It is conceivable that the ACCC, relying on upon advice from WIK-Consult, may be suggesting that Telstra's decision to cooperate with the NBN – rather than compete – was an imprudent decision. It may then be suggesting that this historically imprudent decision is the cause of the loss of economies of scale, and so would justify a disallowance of expenditure under the Fixed Principles. If this is what is being suggested, then in my view it is in error.

In the first instance, the consequence of the historical choice by Telstra to cooperate with NBN Co is that *demand* for fixed line services may be lower than if Telstra had competed with the NBN – there does not seem to be a suggestion that Telstra's expenditure will be higher as a consequence of cooperating (aside from the first category of costs identified above, which are a separate issue). This means that even if Telstra's historical decision to cooperate was imprudent, the input that would be affected is the current-day demand forecast. However, under the Fixed Principles there is no scope for the ACCC to deem the demand for the service to be imprudent and to replace the forecast of actual demand with the hypothetical demand that would have resulted if Telstra had competed. In relation to demand, all the ACCC can do is replace one set of demand forecasts with more accurate demand forecasts. Thus, even if the ACCC decides that Telstra was imprudent to decide to cooperate with the NBN, there is no capacity for the ACCC to use its discretion in relation to operating expenditure and demand forecasts under the Fixed Principles to prevent the loss of economies of scale through migration of customers to the NBN flowing through to prices.

In any event, there seems to me to be little credibility to the argument that Telstra's decision to cooperate with the NBN was an imprudent decision. A better reading of the history is that Telstra was left with little practical choice about whether it should compete with the NBN or to cooperate – this decision was made subject to very direct financial incentives to cooperate, as was summarised in Telstra's disclosure to shareholder at the time:[33]

> *If Telstra does not elect to undergo voluntary structural separation, the CCS Act provides that Telstra must undergo mandatory functional separation and also that the Minister will have the power to implement a legislative prohibition preventing Telstra from bidding for the next major release of wireless spectrum.*
>
> *The only way that Telstra can have certainty that it will avoid the Minister implementing the legislative spectrum prohibition is to choose to voluntarily structurally separate, and to either:*

[33] Telstra, 'Explanatory Memorandum, for the resolution under item 2 at the Annual General Meeting on 18 October 2011: Telstra's Participation in the Rollout of the National Broadband Network', p. 4.

- *give further undertakings to divest its HFC Cable Network and its 50% equity interest in FOXTEL; or*
- *obtain waivers from the Minister regarding the requirement to divest the HFC Cable Network and its FOXTEL interest.*

Telstra has sought to address this by lodging a Structural Separation Undertaking, which does not take effect unless the Minister grants the divestiture waivers.

Both voluntary structural separation and mandatory functional separation are costly and complex initiatives and it is unlikely that Telstra would have chosen to implement either initiative had it not been required to do so by legislation. Telstra's choices under the CCS Act are illustrated in Figure 5.

Moreover, cooperating with the NBN was the preferred option of the government at the time. A fundamental principle of assessments of prudence and efficiency under a building block regime are that the relevant decision or decisions be assessed standing in the shoes of the decision maker – that is, with the information that was available and subject to the regulatory and policy environment. In my view, it would be difficult to conceive of a firm standing in Telstra's shoes not making the same decision that it did.

5. Purpose of payments under the agreement with NBN Co

5.1 Introduction

As indicated above, in its Position Paper and the Draft Decision the ACCC has referred to payments received from NBN Co that relate to customer migration. The implication being that these payments provide compensation to Telstra. The purpose of this chapter is to address these claims.

5.2 Summary of ACCC Draft Decision and WIK-Consult advice

In its chapter on the impacts of the NBN, the ACCC notes that the arrangements between Telstra and NBN Co are formalised in the Definitive Agreements. It states that these arrangements provide for migration payments and infrastructure payments to be made by NBN Co to Telstra. With respect to customer migration, the ACCC notes that NBN Co will pay Telstra a one-off migration payment for each end-user disconnected from its copper network when they are migrated to the NBN in areas covered by NBN Co's fixed line network.[34] The ACCC also identified that the payments between NBN Co and Telstra were a relevant consideration in its approach to the issues that arise from customer migration to the NBN.

WIK-Consult also comments on the payments between NBN Co and Telstra. It took the view that the payments must include compensation for any loss associated caused by the migration of customers to the NBN because this is what a rational business would do if it chose to cooperate with NBN Co:[35]

> *This statement allows for an economic interpretation of what is included in the payment. A rationally acting operator would co-operate with NBN if it would (at least) be fully compensated for any economic loss due to the economic presence of the NBN. This operator would request to be compensated for any costs of stranded assets (which could also be an overcapacity) due to the migration to NBN. Insofar as Telstra is facing fixed costs, the migration of customers to the NBN does not decrease costs to the same extent as demand is decreasing. The degree of fixed asset utilisation decreases due to migration. For stranded assets and occurring overcapacities the legacy network owner would (in a competitive market) no longer get compensation from other users. These stranded assets and the value of overcapacities would not occur if the NBN had not emerged. Insofar they are incremental to the NBN. The rationally acting legacy network operator would allocate those costs to the option of co-operating with NBN Co. Otherwise he would compete to avoid (or reduce) stranded assets and overcapacities and would seek economic compensation from fixed line users (at the retail and wholesale level). This understanding of the economic nature of these payments is independent of the structure of the payments. The intentions are decisive.*

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34 ACCC, 'Public inquiry into final access determinations for fixed line services – primary price terms, Draft Decision', March 2015, pp. 129-130.

35 WIK-Consult, 'Assessment on the efficiency and prudency of Telstra's expenditure forecasts', 5 March 2015, p.24.

5.3 Response to the ACCC Draft Decision

5.3.1 Direct evidence about the intention of the compensation to Telstra

I have been provided with a statement by [redacted], which sets out how Telstra evaluated the agreements that were entered into with NBN Co. I would conclude from this evidence that the payments between NBN Co and Telstra were for the following matters:

- Infrastructure access payments, which provide for large scale access by NBN for certain infrastructure including dark fibre, exchange space, and ducts

- Infrastructure ownership payments, which provide for the transfer of ownership to NBN Co of various infrastructure assets that are linked to progress of the NBN rollout, and

- Disconnection payments, which are progressive payments principally linked to the number of premises disconnected, which provide partial compensation for the loss of an ongoing business after the roll-out of the NBN.

I observe that this view is also corroborated by the materials that were presented to Telstra shareholders at the time the agreement between Telstra and NBN Co.

I note that [redacted] evidence makes it clear that Telstra's computation of the loss under different NBN scenarios – and its financial accounting since then – has never counted upon the loss of value of fixed line assets in the period prior to the rollout of the NBN. A consequence of this is that there is no basis for concluding that compensation for such a loss of value of fixed line assets was included in the compensation agreement. [redacted]

> [redacted]

> [redacted]

Further, [redacted] evidence states that the payments made by NBN Co to Telstra under the Definitive Agreements were never intended to compensate for any potential unrecovered capital cost of copper cable assets, but were for a range of different matters, with [redacted]

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36 Statement of [redacted], paras 39-40, pp. 12-13.
37 Statement of [redacted], para 44, pp. 13-14.

[redacted]

- [redacted]
- [redacted]
- [redacted]
- [redacted]
- [redacted]

When deciding whether to cooperate with NBN Co Telstra sought a vote from shareholders on the matter. An Explanatory Memorandum was prepared for this purpose that set out all of the risks and opportunities that arise through various options available to Telstra; with a specific focus on the recommended option to agree to cooperate with NBN Co.

It would be my expectation that the prospect that Telstra's fixed line assets might be economically stranded by the migration to the NBN Co would be of sufficient significance for this cost to be revealed to shareholders in the Explanatory Memorandum. I note, however, that there is no mention of this possibility in the Explanatory Memorandum. Further, the Explanatory Memorandum provides details of the purpose of the payments under the Definitive Agreements. Again, there is no mention that the payments will make any compensation for stranded fixed line assets.

Moreover, it is also important to recall that the compensation to Telstra was only ever described as being partial compensation. While the markets reacted positively, this reaction was against the expectation in the markets for an even more adverse outcome. Thus, there is also no basis for concluding that Telstra has been engrossed more generally through the deal with NBN Co and that there is therefore something left over for the ACCC to appropriate and transfer to access seekers.

5.3.2 Evidence from the context about the intention of the payments to Telstra

The comments by WIK-Consult embody a critical assumption about the contents of the regulatory regime that is given effect under the Fixed Principles.

- WIK-Consult assumes Telstra can be made to bear the consequences associated with the loss of economies of scale from the migration of customers to the NBN under the regulatory regime, and that Telstra also should have expected this. Given this assumption, WIK-Consult reasons that a rational business would have sought competition for this loss, and therefore assumes that the compensation was in fact received.

- However, if the regulatory regime did not permit Telstra to bear the consequences of the loss of economies of scale, then WIK-Consult's logic applies in reverse – a rational business could not have demanded compensation for this (and NBN Co would have denied it), and so we can infer that no such compensation was in fact received.

Of these alternatives, the second is the most reasonable. I say this because the Fixed Principles quite clearly, in my view, do not permit the ACCC to set prices such that Telstra should bear the consequences of the loss of economies of scale as WIK-Consult assumes and advocates. Moreover, the Fixed Principles were developed at the same time as the Definitive Agreement. Therefore, it is reasonable to assume that these arrangements would have been taken into account in negotiations between NBN Co and Telstra. The consequence being that both parties would have expected that the building block approach, and the roll-forward provisions of the Fixed Principles, would have been upheld such that full cost recovery would be expected and there was no requirement for compensation for asset stranding. Indeed, it would not make commercial sense for NBN Co to have paid any amount for asset stranding compensation given the requirements of the Fixed Principles.

In addition, the Fixed Principles also clarify why Telstra did not see a need to warn investors of the prospect of additional fixed line assets becoming economically stranded during the period of migration to the NBN. It did not need to warn of this prospect because, under the Fixed Principles, the risk should not exist.

I note that the fact that the payments are delivered on the basis of customers migrating to the NBN may drive a perception that the payments may contribute to the cost recovery of assets those customers would have used on the fixed line network. However, it is my understanding that the structure of the payments was intended to align the incentives with those of remaining fixed line users. That is, by making the payments based on migration it better ensures that Telstra remains motivated to maintain and operate the fixed line network for those remaining customers.

Lastly, I note that WIK-Consult also asserted in the passage quoted above that a rational operator would have only co-operated with the NBN "if it would (at least) be *fully compensated for any economic loss* due to the economic presence of the NBN" (emphasis added). This overstates Telstra's position when it negotiated the Definitive Agreements. At that time, the Government had already committed to proceed with the NBN, and so the only question for Telstra (and its only leverage) was whether to compete with the NBN or cooperate with it. Accordingly, all that could be inferred is that Telstra would have demanded compensation for cooperating that was at least sufficient to allow for the additional economic loss that Telstra would have suffered as a result of cooperating rather than competing. As discussed already above, Telstra, quite plainly, has not been fully compensated (through its agreements with NBN Co) for its loss of enterprise value as resulting from the presence of the NBN.