KPMG

cutting through complexity

Gilbert & Tobin

The basis for determining Telstra's base year operating expenditure for fixed line services

April 2015

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1 Introduction

1.1 Background

The Australian Competition and Consumer Commission (**ACCC**) is reviewing pricing for Telstra Corporation Limited's (**Telstra**) seven declared fixed-line services (**FLS**), supplied by Telstra on its copper Public Switched Telephone Network (**PSTN**) and Digital Subscriber Line (**DSL**) networks. In preparation for its final access determinations (**FADs**) for each of these services, the ACCC published in March 2015, its draft decision on primary price terms[1] (the **Draft Decision**).

The ACCC uses its fixed line services model (**FLSM**) to estimate the revenue requirements for the declared fixed line services. The FLSM applies a "Building block" approach to estimating revenue requirements. Forecasts of operating and capital expenditure are major inputs to the FLSM

The ACCC has asked Telstra to provide an explanation of the attribution of costs from its accounting records to the asset classes used in FLSM to allow the ACCC to identify the cost causation underpinning Telstra's expenditure forecasts. While this information was not available to the ACCC prior to it reaching its Draft Decision, Telstra has prepared the following additional information to help explain to the ACCC how it has attributed the operating expenditure of a base year, 2013-14 to FLS asset classes and services for the purposes of the FLSM.

- Telstra Corporation Limited, Further explanation of FY2014 operating costs identified as relevant to the FLSM, March 2015 (**Opex Attribution Document**);
- Telstra Corporation Limited, "Appendix 2: Updated explanation of ITS and TSO expenditure derivation from the General Ledger" (the **Updated ITS and TSO Opex Explanation**);
- Statement of [redacted] and
- the following Excel models and spreadsheets (**Telstra Models**).

Name		Abbreviated name used in this report
FLSM FY2015 to FY2019 v1.2 xlsm	16 March 2015	**FLSM v1.2**
Network FY 2014.xlsm	19 March 2015	**Network Model**
CSD FY 2014.xlsm	16 March 2015	**CSD Model**
ITS Model.xlsm	18 March 2015	**ITS Model**
TOPS BU Support opex FY14.xlsm	16 March 2015	**TOPS Model**
TSO Model.xlsm	19 March 2015	**TSO Model**
TW BU Indirect Opex FY14.xlsm	16 March 2015	**TW Model**

[1] ACCC. Public inquiry into final access determinations for fixed line services - primary price terms, Draft decision, March 2015

Name		Abbreviated name used in this report
Unattributables – Overhead ratio FY14 and forecasts.xlsm	16 March 2015	**UORF Model**
ITS model FY14 20150422_(JL edit).xlsx	22 April 2015	**Updated ITS Model**
TSO model FY14 TW_(JL edit).xlsx	22 April 2015	**Updated TSO Model**
Telstra Corporation		
Revised Fixed Services Forecast Model v1.2	28 April 2015	**FLSM Forecast Model v.1.3**

These documents and models are referred to collectively as the **Background Documents**)

This report provides independent expert opinions on questions asked of the Expert by Gilbert and Tobin, concerning the attributions of operating expenditure to FLS asset classes and services, set out in the Background Documents.

1.2 Purpose

This report addresses the requirements of the Letter of Instruction set out at Appendix A of this report and has the sole purpose of assisting Gilbert & Tobin to provide legal advice to Telstra concerning the ACCC's FADs by addressing the matters set out in Section 1.3 below.

1.3 The matters the Expert has

The Letter of Instruction from Gilbert & Tobin requires the Expert to review the background documents and prepare a report setting out an expert opinion on the following matters:

1. Do the principles and methods that Telstra has used to attribute operating expenditure from Telstra's General Ledger fairly attribute operating expenditure to asset classes and services forming part of the Fixed Line Services Model for the 2013/14 base year, taking into account generally accepted accounting and regulatory principles and precedents?
2. Are the calculations that Telstra has used to derive operating expenditure attributable to asset classes and services forming part of the Fixed Line Services Model for FY2014 set out in the Fixed Services Forecasting Model v1.3 consistent with the principles and methods in Question 1?

The methods and approaches that the Expert utilised to address these matters are described at Section 2 and the Expert's opinions are set out at Section 3 of this report.

A glossary of terms used in this report is set out at Appendix B.

The sources of information the Expert has referred to are set out at Appendix C of this report.

The factual findings and reasons on which the Expert has based his opinions are set out at Appendix E to Appendix M of this report.

The author of the expert opinions set out in this report is:

Keith Lockey
KPMG
147 Collins Street
Melbourne VIC 3000

Keith Lockey's qualifications and experience by which he has gained his specialised knowledge are set out in his CV at Appendix D of this report.

The Expert has read, understood and complied with Practice Note CM7: "Expert witnesses in proceedings in the Federal Court of Australia".

1.4 Warranties and disclaimer

I have made all the enquiries that I believe are desirable and appropriate and no matters of significance that I regard as relevant have, to my knowledge, been withheld from the Court.

The purpose of this report is set out in Section 1.2 and it is not to be used for any other purpose without KPMG's prior written consent.

Accordingly, neither I nor KPMG accept responsibility in any way whatsoever for the use of this report for any purpose other than that for which it has been prepared.

Nothing in this report should be taken to imply that I have verified any information supplied to me, or have in any way carried out an audit of any information supplied to me other than as expressly stated in this report.

The analysis in this report is based on the information set out in this report. I reserve the right to amend any conclusions, if necessary, should any further information become available.

I have been provided with a copy of Federal Court of Australia Practice Note CM7 *Expert Witnesses in Proceedings in the Federal Court of Australia*, which I have read and I agree to be bound by that code of conduct.

Keith Lockey

2 Methods and approaches

2.1 Question 1

To answer the first question:

- Do the principles and methods that Telstra has used to attribute operating expenditure from Telstra's General Ledger fairly attribute operating expenditure to asset classes and services forming part of the Fixed Line Services Model for the 2013/14 base year, taking into account generally accepted accounting and regulatory principles and precedents?

The Expert:

- identified relevant, generally accepted accounting and regulatory principles and precedents to provide a basis of assessment for Telstra's attributions;
- documented the attributions and the principles and methods that Telstra used to make the attributions of operating expenditure to Fixed Line Assets and Services, for the 2013-14 Base Year, that are presented in the FLSM Forecast Model v1.3.;
- compared each of the principles and methods that Telstra used to make each attribution to the generally accepted accounting and regulatory principles and precedents; and
- used those comparisons to make findings on whether Telstra has fairly applied relevant, generally accepted accounting and regulatory principles.

Each of these stages is described further below.

2.1.1 Identification of generally accepted accounting and regulatory principles and precedents

The Expert has referred to the cost allocation fixed principles, set by the ACCC in the 2011 FLS FADs and in its Draft Decision. These principles are:

> *"6.14 Cost allocation factors*
>
> *(a) The allocation of the costs of operating the PSTN should reflect the relative usage of the network by various services.*
>
> *(b) Direct costs should be attributed to the service to which they relate.*
>
> *The cost allocation factors for shared costs should reflect causal relationships between supplying services and incurring costs.*
>
> *(c) No cost should be allocated more than once to any service*
>
> *(d) The determination of cost allocation factors should reflect the principles in 6.14 (a) – (c) above except where reliable information is not available to support the application of the principles;*[2] *"*

The ACCC has stated that the cost allocation fixed principles are subject to assessment, calculation, implementation and/or application, as relevant, by the

[2] ACCC. Public inquiry into final access determinations for fixed line services- primary price terms, Draft decision, March 2015, p. 219

ACCC in making interim and final access determinations for the relevant declared services.[3]

On this basis, the Expert considers that the cost allocation fixed principles provide an appropriate basis for attributing expenditure to FLS.

The Expert has also identified eight generally accepted accounting and regulatory principles founded on precedents. These are:

- Principle 1: Allocators should reflect a cause and effect relationship whenever practicable
- Principle 2: Allocations of cost between Services need to be on mutually consistent bases
- Principle 3: Allocations of cost must be capable of reconciliation to the total cost being allocated
- Principle 4: Cost allocators need to be practical
- Principle 5: Allocators may change over time
- Principle 6: Consistency and quality of allocation objectives and outcomes are more important than consistency of specific allocators
- Principle 7: Causal allocations of cost do not necessarily have continuous or directly proportional relationships with units of Service output
- Principle 8: The quantum of an allocator cannot be prescribed or fixed over multiple periods

These are referred to collectively as the **Generally Accepted Principles**.

Appendix E explains the bases of and precedents for, these principles.

Appendix E also explains how these eight principles are consistent with and give practical effect to, the cost allocation fixed principles.

On these bases, the Expert has adopted the eight principles set out above as a basis for assessing Telstra's attributions.

2.1.2 Documentation of the attributions and the principles and methods that Telstra used to make the attributions

The Expert drew on information set out in the Background Documents and instructions he received, which are set out at Appendix O, to document the attributions and the principles and methods that Telstra used to make the attributions. This documentation includes reconciliations of the amounts attributed by Telstra between FLS and non-FLS assets and services, to the amounts recorded in the General Ledger **(GL)** for each Line of Business and hence for Telstra Operations (**TO**) as a whole, for the adjustments made by Telstra to the TO opex attributions, and for Telstra Wholesale (**TW**).

Appendix F provides an overview of the attribution process. The Expert also summarises below, this process and where in the report he has documented the process.

1. Telstra identified that its GL recorded [redacted] of opex in 2013-14;
2. This total comprises 12 separately identifiable amounts, each uniquely attributable to 12 different business units;

[3] Ibid

3. Telstra assumed that except for certain corporate support costs, which were adjusted for later in the process, the opex attributable to FLS assets and services was recorded only in the TO and TW business units.

4. Telstra then identified opex recorded in TO attributable to FLS assets and services as follows:
   - the total TO opex of [redacted] comprises four separately identifiable amounts, each uniquely attributable in Telstra's GL to four different lines of business;
   - Telstra undertook a series of attributions to firstly attribute expenditure to FLS and non-FLS services and then to attribute FLS expenditure to classes of assets. This resulted in a total of [redacted] of TO opex attributable to FLS assets and services, prior to adjustments.

5. The Expert documented the attributions and the principles and methods that Telstra used to make the attributions for each of the four lines of business that account for the total opex for TO, in the following Appendices:
   - Customer Service Deliver Group (**CSD**) - Appendix G;
   - Networks - Appendix H;
   - IT Solutions (**ITS**) - Appendix I; and
   - Telstra Service Operations (**TSO**) - Appendix J.

6. Telstra then made a number of further adjustments to the TO opex attributed to FLS assets and services, to:
   - remove opex not attributable to FLS assets and services not removed earlier in the process;
   - remove opex recovered by other revenues;
   - reduce the project related operating expenditure attributed to FLS assets and services;
   - add the costs of business support activities attributable to FLS incurred in the TO business unit, not attributed to FLS earlier in the process;
   - add business support costs attributable to FLS incurred in the Corporate and Corporate Accounting business units excluded from the expenditure attributable to FLS, earlier in the process; and
   - reallocate some costs from asset classes, to an additional asset class accounted for by the FLSM, but not by Telstra.

7. These adjustments increased TO opex attributable to FLS assets and services by [redacted] to provide a total of [redacted] of TO opex attributable to FLS assets and services.

8. The Expert has documented these adjustments and the resulting analysis by asset class, of the [redacted] of TO opex attributable to FLS assets and services, in Appendix L.

9. Telstra identified that of a total of [redacted] of TW opex recorded in its GL, [redacted] is directly attributable to FLS services and a further [redacted] is attributable by allocation, to FLS. In addition, an adjustment of [redacted] to attribute corporate support costs to

FLS services, described in Appendix K.1.6 includes an amount of [redacted] which is attributable to TW. This amount is accounted for in the Telstra Models and final attribution and in Table 5-1 of the Opex Attribution Document but was omitted from the descriptions of totals carried forward in the Opex Attribution Document, a total of [redacted] of TW opex attributable to FLS.

10. The Expert has documented the attributions of TW opex in Appendix L.
11. The total of [redacted] of opex attributed by Telstra to FLS in the Opex Attribution Document, comprises [redacted] of TO opex described in point 7 above and [redacted] of TW opex described in point 9 above. For the reasons described in point 9, this total is understated by [redacted].
12. The Expert agreed the amount of [redacted] attributed by Telstra to FLS assets and services for the 2013/14 base year to the corresponding inputs of opex attributed to FLS assets and services in FLSM v1.2
13. Subsequent to the completion of Opex Attribution Document and the input of data to FLSM v1.2, Telstra revised its attributions of ITS expenditure and in the TSO Line of Business, NITO expenditure, and corrected for some insignificant errors in the original attributions identified by the Expert. These revisions had consequential effects on some of the adjustments described in Appendix K and in total resulted in the attribution of a further [redacted] of opex to FLS assets and services. Telstra also included the [redacted] of corporate support costs attributable to TW, described in point 11.
14. The Expert documented in Appendix M, the principles and methods that Telstra used to make the revised attributions for described at point 13 above.
15. The total of opex of [redacted] attributed by Telstra to FLS for the base year compromises the:
    - [redacted] input to the FLSM v1.2 described at point 12 above;
    - [redacted] of corporate support costs attributable to TW; and
    - [redacted] of additional attributed opex described at point 13 above.
16. The expert documented the attributions of [redacted] to FLS assets and services, and agreed these attributions to the corresponding attributions of opex to FLS assets and services for the 2013/14 base year, set out in FLSM Forecast Model v1.3.

2.1.3 Comparison of the principles and methods that Telstra has used to make each attribution to the generally accepted accounting and regulatory principles and precedents

In each Appendix G to Appendix M the Expert has:

- identified each attribution made by Telstra; and
- for each attribution, compared the principles and methods used by Telstra to make the attribution, to the Generally Accepted Principles. The results of these comparisons are set out in the following tables in Appendix G to Appendix M.

Component of attributed opex	Table ref
TO – CSD	Table G - 9, Table G - 10

TO – Networks	Table H - 10, Table H - 11
TO – ITS	Table I - 6, Table I - 8
TO – TSO	Table J - 9, Table J - 10
TO – Adjustments	Table K - 19, Table K - 20
TW	Table L - 7, Table L - 8
Revised attributions and adjustments	Table M - 10, Table M - 11

2.1.4 Findings on whether Telstra's principles and methods fairly attribute operating expenditure

For the purposes of answering this question, the Expert's approach considers that the principles and methods that Telstra has used to attribute operating expenditure are fair:

- if they are consistent with the relevant, generally accepted accounting and regulatory principles, that is, the Generally Accepted Principles; including
- where choices of allocators have been made, choices that are consistent with the Generally Accepted Principles

Cost attributions are not wholly deterministic, as allocators are not always unique and alternative allocators that meet the Generally Accepted Principles may be available to allocate a cost. Generally, choices are often necessary to select allocators from a range of alternatives.

In forming his opinions the Expert has relied on instructions which are set out at Appendix O, including that:

- Telstra Operations, Wholesale, Corporate, and Corporate Accounting are the only Business Units that incur expenditure directly or indirectly attributable to FLS; and
- the opex subject to attribution in those four Business Units is fairly described and completely and accurately quantified in Telstra's GL without duplication or omission.

2.2 Question 2

To answer the second question:

- Are the calculations that Telstra has used to derive operating expenditure attributable to asset classes and services forming part of the Fixed Line Services Model for FY2014 set out in the Fixed Services Forecasting Model v1.3 consistent with the principles and methods in Question 1?

The Expert:

- Compared the overall design and key totals and subtotals of the Telstra Models for consistency with:
  - the attribution processes;
  - GL opex figures input to the Telstra Models; and
  - attributed cost subtotals and totals

  described in Appendix F to Appendix M and sourced from the Opex Attribution Document. The results of this comparison are provided in Appendix F to Appendix M inclusive;
- undertook checks of the arithmetic operation of the Telstra Models for consistency with the attribution steps and calculated subtotals and outputs described in Appendix F to Appendix M. The findings from these checks are set out in Appendix M of this report; and
- agreed the totals of operating expenditure attributable to FLS services that have been analysed and explained in this report and are set out at Table 3-1 to the corresponding operating expenditure attributions for the 2013-14 base year, set out in the FLSM Forecast Model v1.3.

3 The Expert's Opinions

The Expert's opinions on each of the questions posed to the Expert in the Letter of Instruction are set out below, together with summarised reasons for each opinion. Appendix E to Appendix M of this report set out the factual findings on which the Expert's opinions are based and further explain the reasons for the Expert's opinions.

In forming these opinions, the Expert has relied on instructions which are set out at Appendix O and has made assumptions which are also set out at Appendix O.

The Expert's opinions are based wholly or substantially on the Expert's specialised knowledge.

Questions

1 Do the principles and methods that Telstra has used to attribute operating expenditure from Telstra's General Ledger fairly attribute operating expenditure to asset classes and services forming part of the Fixed Line Services Model for the 2013/14 base year, taking into account generally accepted accounting and regulatory principles and precedents?

2 Are the calculations that Telstra has used to derive operating expenditure attributable to asset classes and services forming part of the Fixed Line Services Model for FY2014 set out in the Fixed Services Forecasting Model v1.3 consistent with the principles and methods in Question 1?

Opinions

The Expert's opinions are that:

(a) *The principles and methods used by Telstra to attribute operating expenditure from the General Ledger fairly attribute operating expenditure to asset classes and services forming part of the FLSM for FY2014, taking into account generally accepted accounting and regulatory principles and precedents.*

(b) *Telstra made a material error in the principles and methods used to attribute operating expenditure from the ITS line of business for FY2014, which resulted in FLSM v1.2 significantly understating ITS operating expenditure (the **ITS Error**) and a number of consequential attributions of operating expenditure for FY 2014. While the Expert identified a number of other exceptions, set out in this report, none of these other exceptions were identified (individually or collectively) by the Expert as being significant.*

(c) *The corrections undertaken by Telstra to resolve the ITS Error and the consequential errors, which the Expert reviewed in Fixed Services Forecasting Model v1.3 and associated documentation, fairly attribute operating expenditure to asset classes and services forming part of the FLSM for FY2014, taking into account generally accepted accounting and regulatory principles and precedents*

(d) *The calculations that Telstra has made to derive the operating expenditure attributable to asset classes and services forming part of the FLSM for FY2014 that is set out in in Fixed Services Forecasting Model v1.3, are consistent with the principles and methods referred to in paragraph (a).*

The Expert has answered these questions with reference to the total of [redacted] of opex attributed to FLSs assets and services by Telstra, summarised in the table below which also forms Table M – 2.

Each paragraph of this opinion is reiterated below followed by an explanation of the reasons for the opinion given in the paragraph.

[redacted]

(a) The principles and methods used by Telstra to attribute operating expenditure from the General Ledger fairly attribute operating expenditure to asset classes and services forming part of the FLSM for FY2014, taking into account generally accepted accounting and regulatory principles and precedents.

The Expert considers that the principles and methods that are set out in the Opex Attribution Document and the Updated ITS and TSO Opex Explanation, are consistent with the Generally Accepted Principles.

To explain the reasons for this view, the Expert has:

- firstly summarised the bases of Telstra's attributions in Table 3-2 and

- Table 3-3 below. Table 3-2 represents the first stage of the identification of FLS expenditure, while Table 3-3 represents the methods used to attribute that FLS expenditure to assets classes or in the case of indirect FLS expenditure to FLS services as a whole; and
- then explained how the principles and methods that underlie these bases are consistent with each of the Generally Accepted Principles.

[redacted]

Table 3-2 and

Table 3-3 have been complied by summarising the information set out in Appendix G to Appendix M.

Principle 1: Allocators should reflect a cause and effect relationship whenever practicable

The attributions made by Telstra are consistent with this principle. The reasons for this view are set out below.

Table 3-2 shows that:

- [redacted] of the opex attributed to FLS has been directly attributed (that it is to say that it is wholly and exclusively associated with FLS) to FLS. A direct attribution is a casual relationship where there is an exclusive cause and effect relationship between a service and a cost;
- [redacted] of the cost attributed to FLS has been attributed using a readily identifiable and measurable causal relationship, principally:
  - demand for energy has been use to attribute Networks electricity costs (refer to Appendix H.1.1.1);
  - system usage has been used to attribute ITS and TSO direct IT related expenditure (refer to Appendix I and J.1.2.2 and Appendix M);
  - workforce size has been used to attribute TSO labour costs (refer to J.1.2.1).

The Expert comments that in general, where a causal relationship cannot be measured or reliably estimated, it is not practical to implement a causal allocator. This is recognised by cost allocation fixed principle 6.14 (d) (see Section 2.1.1) and Appendix E, which shows that this is also recognised by regulatory precedents.

Table 3-2 also show sthat almost all of the remaining [redacted] of cost that has not been attributed to FLS on directly attributable or other causal basis, has been attributed using proxies for a causal bases.

The principal proxies for causal allocators are:

- demand for energy which has been used to attribute Networks' building and rental costs (refer to Appendix H.1.1.2, Appendix H.1.1.3 and Appendix H.2). Table H - 10 also explains:
  - why on a first principles basis, this allocator provides a proxy for causal allocator that is consistent with the Generally Accepted Principles; and
  - that other information about the attribution of approximately [redacted] of the Networks building maintenance contract costs between FLS and non FLS, is consistent with the allocation outcomes provided by the proxy; and
- ratios of indirect expenditure necessary to enable and facilitate other FLS activities. The principal examples of these allocations arise for TO business support expenditure of [redacted] (see Appendix K.1.4), Telstra corporate business support expenditure of [redacted] (see K.1.6) and CSD indirect opex of [redacted] (see Appendix G.1.3). These measures provide proxies for casual allocators because they assume a link between direct and indirect activity, and on this basis direct expenditure provides a relative measure of direct activity and hence demand for the indirect activity. Table G - 9 also cites precedents for the use of this form of allocator for attributing cost between services, for regulatory purposes.

Table 3-2 and

Table 3-3 also show that less than [redacted] of the expenditure attributed to FLS has been attributed by Telstra on a judgmental basis that does not appear to be capable of independent replication. The Expert is unable to form a view on these attributions, but the amounts involved are not significant.

Table3-3 also shows that expenditure has been attributed to FLS assets or services on a directly attributable basis or using causal allocators or proxies. The percentage of directly attributable expenditure in Table 3-3 is higher than in Table 3-2 because of the amount of FLS expenditure which is directly attributed to services as a whole (indirect FLS expenditure) .

Principle 2: Allocations of cost between Services need to be on mutually consistent bases

This principle would be breached if different allocators were to be used to allocate a single category of cost to different assets or services. In such a case it would not be possible to demonstrate that a shared cost has been allocated completely and that the allocated costs in total equal the shared cost.

Appendix G to Appendix M show that the Expert found no instances where more than one allocator was used to attribute a single cost. On this basis the Expert concludes that Telstra's attributions are consistent with Principle 2.

Principle 3: Allocations of cost must be capable of reconciliation to the total cost being allocated

This arithmetic check is necessary to demonstrate that cost has been neither created nor lost as a result of the attribution; and that the resulting attributions fairly reflect the stated relationship between each Service and the total shared cost.

Figure F – 2, and the calculations and flow charts in Appendix F to Appendix M and the results of the tests and checks of calculations set out in in Appendix M, demonstrate that:

- the [redacted] of opex that the Expert has been instructed was recorded in Telstra's GL for the base year, has been fully attributed between FLS and non FLS without omission or duplication; and
- the calculation of the [redacted] of opex attributed to FLS assets or services in the base year can reconciled to the [redacted] of opex that the Expert has been instructed was recorded in Telstra's GL for the base year.

On these bases the Expert concludes that Telstra's attributions are consistent with Principle 3.

Principle 4: Cost allocators need to be practical

The Expert's consideration of Principle 1 above, explains that:

- the bases of direct attribution, that Telstra has employed is capable of ready recognition from classifications in Telstra's GL; and/or
- the casual allocators and proxies for causal allocation that Telstra has employed or determined are capable of measurement and independent replication:

On these bases the Expert concludes that Telstra's attributions are consistent with Principle 4.

Principle 5: Allocators may change over time

Principle 5 is not a relevant consideration because the Expert has considered only a single year's attributions.

Principle 6: Consistency and quality of allocation objectives and outcomes are more important than consistency of specific allocators over time

Principle 5 is not a relevant consideration because the Expert has considered only a single year's attributions.

Principle 7: Causal allocations of cost do not necessarily have continuous or directly proportional relationships with units of Service output

This Principle is relevant where there is causal link between a need for expenditure and an item of expenditure, but the quantum of the item of expenditure may not vary with units of service delivery or output and/or may not be caused or triggered by individual categories of similar services. Corporate support costs are an example. A need for these activities and costs can be caused by the first unit of or general need for FLS delivery, but there may be no casual or meaningful relationship between the number and kind of asset classes and the costs incurred. Telstra's attribution of corporate and operations support cost and other indirect cost to FLS, but not individual assets with which a causal relationship may not exist, is consistent with this Principle.

Principle 8: The quantum of an allocator cannot be prescribed or fixed over multiple periods

Principle 8 is not a relevant consideration because the Expert has considered only a single year's attributions.

(b) Telstra made a material error in the principles and methods used to attribute operating expenditure from the ITS line of business for FY2014, which resulted in FLSM v1.2 significantly understating ITS operating expenditure (the ITS Error) and a number of consequential attributions of operating expenditure for FY 2014. While the Expert identified a number of other exceptions, set out in this report, none of these other exceptions were identified (individually or collectively) by the Expert as being significant.

(c) The corrections undertaken by Telstra to resolve the ITS Error and the consequential errors, which the Expert reviewed in Fixed Services Forecasting Model v1.3 and associated documentation, fairly attribute operating expenditure to asset classes and services forming part of the FLSM for FY2014, taking into account generally accepted accounting and regulatory principles and precedents

Appendix I and Appendix M describe the nature of the ITS and Appendix M also describes how Telstra revised its attributions to address the ITS error and a number of further errors which the Expert identified.

Table 3-4 sets out:

- the [redacted] of adjustments made by Telstra to correct for three errors identified by the Expert in this report; and
- a remaining difference identified by the Expert, which Telstra did not correct for, of less than [redacted]. The Expert does not consider that this uncorrected difference is significant for his opinion.

Table 3-4: Summary of exceptions identified by KPMG from Generally Accepted Principles

No	Issue	(Understatement) or overstatement of opex attributable in total to FLS assets or services
Errors corrected by Telstra		
1	Telstra's Network model overstates network maintenance contract opex	[redacted]
2	TO business support costs not attributed to propex. This is an indirect cost that does not impinge on attributions to different asset classes	[redacted]
3	It is not appropriate to use two years' data to develop allocators for a single year's direct operating expenditure for ITS direct, TSO direct (NITO) and ITS and TSO indirect operating expenditure	[redacted]
4	Other understatements of ITS opex and consequential opex understatements	[redacted]
Total (See Table M - 1)		[redacted]
Uncorrected difference		
5	Unreconciled difference in propex adjustments	[redacted]

Appendix H.3 describes the matter of overstated network maintenance contract opex, which Telstra corrected for and is therefore no longer relevant.

Appendix K.1.4 describes the understatement of TO business support costs which Telstra also corrected for and is therefore no longer relevant.

Appendix I and Appendix J describe matters that the Expert considered to be exceptions, because Telstra calculated its attribution of ITS opex and TSO NITO opex on an average of two year's costs. However, the revised attributions in Appendix M do not take this approach and supersede the attributions in Appendix I and Appendix J. On this basis the exceptions reported in Appendix I and Appendix J are no longer relevant.

Appendix M also sets out the analysis which the Expert undertook which led him to form a view that the corrections which Telstra undertook, take into account generally accepted accounting and regulatory principles and precedents.

(d) ***The calculations that Telstra has made to derive the operating expenditure attributable to asset classes and services forming part of the FLSM for FY2014 that is set out in in Fixed Services Forecasting Model v1.3, are consistent with the principles and methods referred to in paragraph (a).***

This opinion is constrained to the factual findings of the results of the arithmetic checks and tests detailed in Appendix M of whether:

- the Telstra Models operate in a way that is consistent with the intention of the attribution principles and methods set out in the Opex Attribution Document and the Updated ITS and TSO Opex Explanation. These tests and checks did not constitute an audit and, accordingly, the Expert expresses no opinion on Telstra's Models under Auditing and Assurance Standards;
- operating expenditure attributed between FLS and non-FLS matches operating expenditure extracted from Telstra's GL;
- the costs identified within each attribution step can be reconciled to each other; and
- the operating expenditure attributed to FLS assets and services in the Fixed Services Forecasting Model v1.3 for the 2013-14 Base Year agree to the totals derived from the Expert's analysis set out in Table 3-1.

The results of these tests and checks show that:

- with one exception that was not significant and has been corrected for by Telstra (refer Appendix H.3), there is no information to suggest that the Telstra Models do not operate in a way that is consistent with the intention of the attribution principles and methods set out in the Opex Attribution Document;
- that all operating expenditure attributed between FLS and non-FLS reconciles to the financial information that the Expert has been instructed, has been extracted from the GL, and without duplication or omission. These matters are also documented in Appendix F to Appendix M;
- that the key inputs and outputs of each step of attribution between the GL and what is attributed between FLS and non-FLS can be reconciled to each other in full, and without duplication or omission. These matters are also documented in Appendix F to Appendix M; and
- the operating expenditure attributed to FLS assets and services in the Fixed Services Forecasting Model v1.3 for the 2013-14 Base Year does agree to the Expert's analysis summarised in Table 3-1.

4 Expert's statement

Keith Lockey has made all the inquiries that Keith Lockey believes are desirable and appropriate and that no matters of significance that Keith Lockey regards as relevant have, to Keith Lockey's knowledge, been withheld from the Court.

Appendix A: Letter of instruction from Gilbert & Tobin Lawyers

Partner Simon Muys
Contact Geoff Petersen
T +61 2 9263 4388
gpetersen@gtlaw.com.au
Our ref SJM:GCP:1022649

GILBERT TOBIN
LAWYERS

Melbourne
101 Collins Street Melbourne VIC 3000
Australia
GPO Box 90 Melbourne VIC 3001
T +61 3 8656 3300 F +61 3 8656 3400
www.gtlaw.com.au

30 April 2015

By email

Mr Keith Lockey
Director, Advisory
KPMG
147 Collins St
Melbourne VIC 3000
Email klockey@kpmg.com.au

Confidential and privileged

Dear Mr Lockey

Review of Telstra's base year operating expenditure

We are currently advising Telstra Corporation Ltd (**Telstra**) in relation to a review of pricing for declared fixed-line services currently being conducted by the Australian Competition and Consumer Commission (**ACCC**).

The ACCC is currently conducting a review (the **FAD Inquiry**) of pricing for Telstra's declared fixed-line services (the Unconditioned Local Loop Service (**ULLS**), Line Sharing Service (**LSS**), Wholesale Line Rental (**WLR**), Local Carriage Service (**LCS**), PSTN Originating and Terminating Access (**PSTN OTA**), and Wholesale ADSL). At the conclusion of this inquiry the ACCC will publish final access determinations (**FADs**) for each of these services which will include (among other things) revised service prices.

Telstra is now seeking further assistance from you in relation to this matter. Telstra would like you to undertake a further expert review of the principles and methods that Telstra has used to attribute operating expenditure from Telstra's General Ledger to asset classes and services forming part of the Fixed Line Services Model for the 2013/14 base year, and to review the calculations undertaken by Telstra in applying those principles and methods.

We request that you prepare a report setting out the findings from your review.

Background

As detailed in earlier instruction letters, the ULLS, LSS, WLR, LCS, PSTN OTA and WADSL are each declared services under Part XIC of the *Competition and Consumer Act 2010* (Cth) (**CCA**), and as such certain access obligations apply to these services. Each of these services is also subject to FADs made by the ACCC under section 152BC of the CCA, which specify (among other things) the price terms on which Telstra is to comply with its access obligations for each service.

The current FADs for each of the declared fixed-line services were due to expire on 30 June 2014. The ACCC has therefore commenced an inquiry into making new (replacement) FADs for each of these services, and has proposed to extend the current FADs until such time as the replacement FADs take effect.

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Each of the current FADs contain fixed principles provisions, which must be maintained in any replacement FAD, at least until their nominal expiry date.

Scope of work

For the purpose of preparing your report, we have provided you with the following:

- the Fixed Line Service Model v1.2 and supporting Telstra models associated with the determination of base year opex (10 March 2015);
- a document titled 'Updates to the FLSM' setting out amendments made to correct errors in FLSM v1.1 corrected in FLSM v1.2 (18 March 2015);
- the further explanation of FY2014 operating costs identified as relevant to the FLSM (dated March 2015) (18 March 2015);
- Fixed Services Forecast Model version 1.2 (28 April 2015);
- an updated explanation of ITS and TSO expenditure derivation from the General Ledger (30 April 2015);
- a statement of [redacted] and
- TEM Reporting Guidelines (dated January 2015) (28 April 2015).

We would like you to review the provided models and documents, and prepare a report setting out your expert opinion on the following matters:

1. Do the principles and methods that Telstra has used to attribute operating expenditure from Telstra's General Ledger fairly attribute operating expenditure to asset classes and services forming part of the Fixed Line Services Model for the 2013/14 base year, taking into account generally accepted accounting and regulatory principles and precedents?
2. Are the calculations that Telstra has used to derive operating expenditure attributable to asset classes and services forming part of the Fixed Line Services Model for FY2014 set out in the Fixed Services Forecasting Model v1.3 consistent with the principles and methods in Question 1?

Guidelines for preparing your report

The Guidelines for Expert Witness in the Federal Court of Australia are attached to this letter. Telstra is seeking a rigorously prepared independent view which may be used in the context of regulatory decision making and in any subsequent review of the ACCC's final decision. Therefore you are requested to follow the Guidelines to the extent reasonably possible.

In particular, as part of any report please:

(a) identify your relevant area of expertise and provide a curriculum vitae setting out the details of that expertise;

(b) only address matters that are within your expertise;

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(c) where you have used factual or data inputs please identify those inputs and the sources;

(d) if you make assumptions, please identify them as such and confirm that they are in your opinion reasonable assumptions to make;

(e) if you undertake empirical work, please identify and explain the methods used by you in a manner that is accessible to a person not expert in your field;

(f) confirm that you have made all the inquiries that you believe are desirable and appropriate and that no matters of significance that you regard as relevant have, to your knowledge, been withheld from your report; and

(g) please do not provide legal advocacy or argument and please do not use an argumentative tone.

Timing

We require a final report by 30 April 2015.

If you have any questions, please do not hesitate to contact us.

Yours sincerely

Simon Muys
Partner
T +61 3 8656 3312
smuys@gtlaw.com.au

Geoff Petersen
Lawyer
T +61 2 9263 4388
gpetersen@gtlaw.com.au

Appendix B: Glossary of terms

ABM	Activity-based management
ACCC	Australian Competition and Consumer Commission
Allocation	The attribution of a cost to more than one asset or service.
Allocator	The relationship that effects an allocation.
CAF	Cost Allocation Framework
CAN	Customer Access Network
Causal	A causal basis of attribution attributes costs to an asset or service on the basis of a cause and effect relationship between the: • creation, maintenance or utilisation of an asset; or • supply of a service; and the incurrence of the cost.
CFBU	Client Facing Business Unit
CMPE	Consumer and Mobility Product Engineering
Cost allocation fixed principles	The fixed principle provisions that are to apply to the FAD, set out in paragraph 6.14 of Appendix D of the document "ACCC. Public inquiry into final access determinations for fixed line services- primary price terms, Draft decision", March 2015
CSD	Customer Service Delivery Group
DSL	Digital Subscriber Line
DBoR	Database of Record
Directly attributable	A cost is directly attributable to a service or asset if it is wholly and exclusively associated with that service or asset.
FADs	Final Access Determinations
FDAE	Fixed and Data Access Engineering
FLS	Fixed Line Service(s)

FLSM	Fixed Line Services Model
FTE	Full Time Equivalent
FVNMS	Fixed Voice and Networks Manager and Staff
Generally Accepted Principles	The eight principles of cost attribution described at Appendix E of this report
GL	General Ledger – Telstra's primary accounting records that record among other things, the opex that Telstra incurred in the 2013-14 financial year
ITS	IT Solutions
LOB	Line(s) of business
LSS	Line sharing services
LSS	Line Spectrum Sharing
NAO	Network Service Assurance Operations
NBN	National Broadband Network
NECM	Network Electricity (or Energy) Consumption Model
NECTAR Model	Telstra's Joint Network Costing Model
NIO	Network Infrastructure Operations
NITO	Network IT Operations
NSF	Network Service and Facilities
Opex	Operating expenditure. Operating expenditure is non capital expenditure that excludes depreciation, amortisation and interest costs
Propex	Project related operating expenditure
PSEDS	Product and Solutions Engineering Director and Staff
PSTN	Public Switched Telephone Network
STS	Standard telephone services
TEBA	Telstra Equipment Building Access

Telstra	Telstra Corporation Limited
TEM	Telstra Economic Model
TO	Telstra Operations
TRE	Transport and Routing Engineering
TSO	Telstra Service Operations
TUSMA	Telecommunications Universal Service Management Agency
TW	Telstra Wholesale
ULL	Unconditioned Local Loop

Appendix C: References

ACCC, Final Access Determinations No. 1 to No. 6, 20 July 2011, as varied 14 December 2011

ACCC. Public inquiry into final access determinations for fixed line services- primary price terms, Draft decision, March 2015

Australian Energy Markets Commission, National Electricity Rules

Aurora Energy, Cost Allocation Method, May 2009

Jemena Electricity Networks (Vic), Cost Allocation Methodology, 18 February 2010

KPMG, The key principles underlying regulatory cost allocations, 17 April 2014

Statement of [redacted] April 2015

SunWater, QCA review of irrigation prices – Supplementary information, Allocation of centralised costs, February 2011

Telstra Corporation Limited, Appendix 2. Updated explanation of ITS and TSO expenditure derivation from the General Ledger, April 2015

Telstra Corporation Limited, Cost Allocation Framework for the ACCC Fixed Line Services Model, Framework and Model Guide, June 2014

Telstra Corporation Limited Excel models and spreadsheets

Name	**Date of receipt by the Expert from Gilbert & Tobin**
FLSM FY2015 to FY2019 v1.2 xlsm	16 March 2015
Network FY 2014.xlsm	19 March 2015
CSD FY 2014.xlsm	16 March 2015
ITS Model.xlsm	18 March 2015
TOPS BU Support opex FY14.xlsm	16 March 2015
TSO Model.xlsm	19 March 2015
TW BU Indirect Opex FY14.xlsm	16 March 2015
Unattributables – Overhead ratio FY14 and forecasts.xlsm	16 March 2015
ITS model FY14 20150422_(JL edit).xlsx	22 April 2015
TSO model FY14 TW_(JL edit).xlsx	22 April 2015
Revised Fixed Services Forecast Model v1.2	28 April 2015

Telstra Corporation Limited, Further explanation of FY2014 operating costs identified as relevant to the FLSM, March 2015

Telstra Corporation Limited, TEM Reporting Guidelines, January 2015

Appendix D: Curriculum Vitae

Keith Lockey
Director
KPMG
147 Collins Street
Melbourne VIC 3000

Certifications & Professional Memberships

- BSc (Hons) (Environmental Sciences), University of Lancaster
- Institute of Chartered Accountants in England and Wales

Profile/Overview

Keith co-leads KPMG's infrastructure, pricing and economic regulation team. He specialises in advising governments, utilities and other economically regulated industries on matters of industry reform, economic regulation and pricing and funding arrangements. Keith has expertise in undertaking financial analyses and costing to inform the determination of regulated prices and revenues. He has worked almost exclusively in this area since 1995.

Experience – examples

Legal advisors to ATCO Gas Australia – Expert report on efficient costs – Keith wrote an expert report that used benchmarking to examine the efficiency of corporate support costs and inter-company charges forecast in an access arrangement revision for the MWSW Gas Distribution System and compared forecast costs to historic levels of expenditure.

Electricity Distribution Network Service provider (DNSP) – Cost Allocation Method (CAM) – Keith assisted a DNSP to draft and gain regulatory approval of a revised CAM prior to the submission of its regulatory proposal and the publication by the Australian Regulator of a framework and approach to the DNSP's revenue determination.

Legal advisors to Telstra Corporation – Key principles underlying regulatory cost allocations. Keith drafted an expert report on the principles and precedents that underpin cost allocation approaches for regulatory purposes in Australia.

Legal advisors to Telstra Corporation – Review of Telstra's cost allocation methodology. Keith provided expert opinions on the consistency of Telstra's models for allocating costs to declared fixed line services with generally accepted regulatory and cost allocation principles.

Legal advisors to Telstra Corporation - Fixed Line Services pricing Model (FLSM). Keith was the joint author of an expert report on the operation integrity and fitness for purpose of the ACCC's FLSM.

Major Australian telecommunications service provider: Regulatory imputation test – Keith carried out a regulatory imputation test to assess whether charges for third party mobile network access were sufficient to facilitate retail competition. This involved examining cost reports prepared in accordance with regulatory accounting separation requirements, to determine and report on, the relevant costs of service.

Major telecommunications provider - Keith led a KPMG team that undertook economic and financial analysis to help determine whether access prices provide sufficient margins to facilitate competition.

Australian Energy Regulator – Review of Cost Allocation Methods (CAMs). Keith assisted the AER to review the CAMS of a number of businesses for compliance with the requirements of the National Electricity Rules and the AER's guidance, and to advise the AER on possible future directions for its accounting separation requirements in the electricity sector.

Office of the Tasmanian Economic Regulator. Keith advised the regulator on the development of a regulatory accounting guideline and reporting templates for the water industry.

National Heavy Vehicle Regulator Project Office – Cost Consultancy. Keith led a team that collected and analysed the forecast costs and supporting assumptions provided by jurisdictions throughout Australia, of implementing arrangements for the national regulation of heavy vehicles.

National Rail Safety Regulator Project Office – Cost and capability study. Keith led a team that assessed the costs and capabilities of jurisdictional rail safety regulators, prior to the formation of a national regulator.

Queensland Competition Authority – Water business price monitoring. Keith led a team that developed templates to collect financial information to assist the QCA with monitoring price and a financial model for analysing that information in accordance with building block principles.

Office of the Tasmanian Energy Regulator: Redesign and simplification of regulatory accounting requirements - Regulatory developments and modifications to the templates led to the need to review Tasmania's regulatory accounting requirements for the electricity distribution industry.

Allgas: Assistance with compliance with regulatory accounting requirements - Keith helped this gas network operator to develop reporting procedures to help demonstrate compliance with regulatory accounting requirements.

Electricity Transmission Network Owners Forum (ETNOF): Transmission cost allocation guidelines 2007 - Keith carried out an engagement for ETNOF (which represents all the principal Australian Electricity Transmission Businesses) to review draft Cost Allocation Guidelines published by the Australian Energy Regulator.

Transend Networks Ltd: AER Cost Allocation Methodology Manual (2007 and 2008) - Keith led a KPMG team that drafted a "Cost Allocation Methodology" required by the Australian Energy Regulator, to demonstrate the allocation of costs between different transmission services in accordance with the National Electricity Rules. KPMG also drafted an accompanying cost allocation and regulatory reporting procedures and process manual to assist Transend.

Transend Networks Ltd: Allocation of shared costs to unregulated business activities – Keith advised on the consistency of an allocation approach developed by Transend with good business practice and regulatory requirements.

Queensland electricity network businesses: Electricity industry regulatory accounting guidelines - Keith was engaged by industry to assess the Queensland Competition Authority's Guidelines published as part of the 2005 Price Determination. .

Australian Competition and Consumer Commission: Record Keeping Rules - Keith reviewed draft accounting separation and cost allocation rules (regulatory accounting requirements) for the postal industry drafted by the ACCC and provided a range of suggestions and advice to improve their workability.

Australian Competition and Consumer Commission: Accounting Ring Fencing Guidelines for Gas Transmission Businesses - The Commission engaged Keith to review a jurisdictional regulator's guideline as a basis for accounting ring fencing for gas transmission pipeline service providers, under the Gas Code. Keith was then engaged to draft a guideline. This was designed to allow service providers to meet the Commission's objective of demonstrating compliance with the National Gas Code, while following generally accepted accounting principles and seeking to minimise the regulatory burden for both service providers and the Commission.

Major New Zealand gas distribution and transmission business: Advice on regulatory accounting requirements - Keith assisted a major gas network business to comply with the New Zealand Commerce Commission's Avoided Cost Accounting Method ("ACAM") for regulatory financial reporting.

Department of Infrastructure, Victoria: Development of accounting information reporting requirements for public transport franchisees - Keith was engaged by the Victorian government throughout 2002 and 2003 to identify financial and performance reporting requirements for monitoring and assessing the profit levels of Victoria's public transport franchisees. The outputs of this work included developing and consulting with franchisees on an information requirements guideline.

Transgrid – Negotiated Services Pricing – Keith led a team that developed a model that enabled prices to be calculated on the basis of both standalone and incremental allocations of cost, in accordance with the National Electricity Rules.

Northern Territory Power and Water Corporation: Development of an industry based cost ring fencing guideline - Keith developed a "self-regulating" cost ring fencing guideline n.

Office of the Tasmanian Electricity Regulator: Electricity Industry Regulatory Accounting Guidelines - In consultation with regulatees and with regard to the ACCC's proposals for transmission pricing, Keith developed the regulator's original regulatory accounting guidelines for distribution and transmission businesses.

Electricity network businesses throughout Australia: Review of regulatory accounting submission - Keith has been engaged by different electricity networks to review regulatory accounts for compliance with regulatory requirements, prior to submission.

Australian Competition and Consumer Commission: Review of Electricity Transmission Business Co Regulatory Information Guidelines - Keith reviewed and provided constructive advice to the ACCC on proposed regulatory information guidelines to help it achieve its objectives in a practical, workable way aiming to minimise the information burden on business. Subsequently a small team led by Keith drafted revised Guidelines.

Office of Regulator-General, Victoria ("ORG"): Regulatory management secondment - Shortly after its establishment, Keith was seconded to the ORG for 15 months to: manage and implement the process of acquiring and analyzing regulatory accounts from electricity distribution businesses. This included drafting Issues 1 and 2 of the regulator's cost allocation and regulatory accounting guideline.

Australian Competition and Consumer Commission - Keith organised and participated as a key speaker at a one-day workshop held with the ACCC on regulatory accounting, that explored both issues of principle and practice.

Legal advisors to MurrayLink - benchmarking of efficient forecast business costs - Keith has provided independent expert advice on issues of cost efficiency and allocation key to cost recovery.

CitiPower and Powercor – Independent expert reports on the efficiency of shared costs. Keith authored reports that assessed whether the costs of shared network operating services attributed to each network were prudent and efficient.

Assessment of potential for cross-subsidies in a vertically integrated energy utility - Keith undertook a study that reviewed the potential for economic cross- subsidies both within the utility and with other parties to assist with planning disaggregation options.

Power and Water Authority: Assessment of cost allocations and the bases of CSO payments for electricity supply - Keith advised on appropriate responses to government guidelines on and a regulator's review of, these issues.

Legal advisors the Goldfields Gas Pipeline and the Victorian Gas Transmission System - benchmarking of efficient forecast business costs - Keith provided independent expert advice on issues of cost efficiency and allocation key to access arrangement revisions.

National Transport Commission – Forward Looking Cost Base Discussion Paper – Keith wrote and presented a paper that examined the potential characteristics of how a forward looking cost base could be applied to determine charges for the use of the roads network by heavy vehicles.

Water Utility – Cost allocation and capitalisation. Keith led a small team that developed options for QUU to refine and redevelop its cost allocation and capitalization policies to better meet a range of regulatory, financial reporting and operational objectives.

Department of Infrastructure and Transport – Costing of Security ID card provision – Keith led a team that costed service provision.

Appendix E: Relevant accounting principles and precedents

The Expert has referred to his knowledge of regulatory accounting principles and precedents in Australia and his knowledge of generally accepted accounting principles, to derive the following framework of principles (**Generally Accepted Principles)** to provide a basis for assessing the fairness of Telstra's attributions of expenditure to FLS.

This appendix sets out the principles, explains why they are appropriate on an accounting first principles basis, and how they are consistent with the precedents provided in the ACCC's cost allocation fixed principles and other regulatory precedents.

The Expert's view is that the Generally Accepted Principles stated in this appendix, are appropriate to an objective of fairly stating opex attributable to FLS asset classes or services in the 2013-14 base year. This is because:

- the Generally Accepted Principles have an objective of fairly stating fully distributed cost attributions for general purposes and the Expert has not identified any special circumstances or requirements of the attribution of opex to FLS assets and services that would cause a general purpose approach to be inapplicable;
- the Generally Accepted Principles and the ACCC's cost allocation fixed principles are mutually consistent. The Generally Accepted Principles provide practical guidance on cost attributions that are consistent with the ACCC's cost allocation fixed principles; and
- the ACCC's cost allocation fixed principles are appropriate to an objective of fairly stating opex attributable to asset classes or services forming part of the FLSM in the 2013-14 base year.

E.1 The principles

Principle 1: Allocators should reflect a cause and effect relationship whenever practicable

This is necessary to provide a rational, transparent and replicable basis for selection for an allocation.

A cause and effect relationship also allows efficient costs to be allocated on a basis that maintains the nexus between the efficient cost and the factors that cause that efficient cost to arise. The use of a causal relationship where practicable to effect cost allocations is a common regulatory accounting requirement. A principal precedent is provided by the National Electricity Rules' (**NER**) Cost Allocation Principles.[4]

For example clause 16.5.2(3) of the NER[5] requires that only the following costs may be allocated to a particular category of service.

1. *"costs which are directly attributable to the provision of those services;*
2. *costs which are not directly attributable to the provision of those services but which are incurred in providing those services, in which case such costs must be allocated to the provision of those services using an appropriate allocator which should:*

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[4] Australian Energy Market Commission, National Electricity Rules, Clause 16.5.2
[5] Australian Energy Market Commission, Clause 16.5.2.

(A) *except to the extent the cost is immaterial or a causal based method of allocation cannot be established without undue cost and effort, be causation based; and*

(B) *to the extent the cost is immaterial or a causal based method of allocation cannot be established without undue cost and effort, be an allocator that accords with a well accepted cost allocation method;"*

The Expert also notes that a direct attribution is a causal relationship where there is an exclusive causal relationship between a cost and a service.

To the best of the Expert's knowledge, these principles replicate precedents set by earlier regulatory accounting and cost allocation guidelines published by jurisdictional regulators such as the Office of the Regulator-General in Victoria. For example, Section 3.5 of the Office of the Regulator-General's Guideline[6] also required that costs be allocated:

- using direct attribution wherever possible; and
- using causal allocators wherever practicable for costs which cannot be directly attributed.

A further, more recent example of the application of these principles can be found in Section 4.3 of the Office of the Tasmanian Economic Regulator's Water and Sewerage Accounting Ring Fencing Guideline published in May 2013.

Principle 2: Allocations of cost between Services need to be on mutually consistent bases

This is an arithmetic requirement. If different allocators are used to allocate a single category of cost to different services then it will not be possible to demonstrate that:

- a shared cost has been allocated completely and that the allocated costs in total do not exceed the shared cost; and
- the resulting allocations of cost represent allocations of the cost subject to allocation.

Regulatory accounting requirements often include requirements that a cost shall not be allocated more than once. The ACCC's cost allocation fixed principle (c) is an example. In the Expert's view, requirements of this kind exemplify Principle 2.

Principle 3: Allocations of cost must be capable of reconciliation to the total cost being allocated

This basic arithmetic check complements Principle 2. It is necessary to demonstrate that:

- cost has been neither created nor lost as a result of the allocation; and
- the resulting allocations fairly reflect the stated relationship between each Service and the total shared cost.

In addition to this being a basic check that is valid regardless of regulatory requirements, it is often explicitly required in regulatory accounting and cost allocation guidelines. The Office of the Regulator-General's Electricity Industry Guideline No 3

[6] Office of the Regulator-General Victoria, Electricity Industry Guideline No 3, Issue No 2, November 1997, p. 3.4.

provided the original precedent for Australian access regulated businesses with its requirements for disaggregation statements. A further example is provided by the ACCC's draft regulatory reporting guidelines for gas pipeline service providers (May 2004) which also required disaggregation statements.

Principle 4: Cost allocators need to be practical

This principle is referred to in the summary for Principle 1. A cost allocation that cannot be practically implemented and replicated is unlikely to be acceptable by a regulator as a basis to develop and assess costs under a building blocks approach. In practical terms, appropriate judgements may need to be made to assess and trade off the identification and measurement of precise cause and effect relationships, with potentially less precise surrogates that may be better capable of implementation.

The examples of precedent requirements for Principle 1 given above, also provide examples of precedents for this Principle.

Principle 5: Allocators may change over time

Causal allocators seek to reflect underlying practical and operational cause and effect relationships between Services and shared costs. Because these relationships can be expected to change as technologies and operations change, including for reasons of improving efficiency, it is reasonable to expect that allocators may change correspondingly. Further as information systems change, it may become possible over time, to better identify or measure allocators that more closely describe causal relationships than had been the case in the past.

Because of these reasons, allocators should not be regarded as static or permanent, although except where a Service is undergoing frequent or significant change, they should also not be expected to change frequently.

The Expert is not aware of Australian regulatory accounting requirements or guidelines for access regulated industries prescribing allocators. Rather, they are outcome focused, requiring businesses to choose allocators that meet the requirements of Principles 1 and 4. For example, the ACCC's Airport prices monitoring and financial reporting guideline, June 2009 adopts a principles-based approach to cost allocation selection, which is set out in Section 3.4 "Account Item Allocation Principles" of that document.

Principle 6: Consistency and quality of allocation objectives and outcomes are more important than consistency of specific allocators over time

This is a corollary of Principle 5. If allocators were to be fixed permanently, they could result in inaccurate or inefficient allocations in the longer term.

This principle is also illustrated by the precedents for Principle 6 as well as frequent requirements for the substance of transactions to be reported in preference to their form. Section 3.5 of the ACCC's Airport price monitoring and financial reporting guideline "Commercial substance to prevail over legal form" is such an example.

Principle 7: Causal allocations of cost do not necessarily have continuous or directly proportional relationships with units of Service output

Not all cause and effect relationships are ones of direct proportionality. Also, the cause of a change in cost may be other than an incremental change in a unit of Service output. A cost may be necessary for a Service but is not triggered or caused by units of Service outputs.

In the Expert's view, this Principle is exemplified by what in the Expert's view is a generally accepted concept that some costs are "fixed". Regulatory accounting guidelines do not differentiate such costs from "variable" costs. Rather, the principles-based approach which requires allocators to be causal where practicable, addresses these matters.

Principle 8: The quantum of an allocator cannot be prescribed or fixed over multiple periods

This is because allocators should reflect underlying operational activity and realities. In the normal course of events for many costs, the proportion of a shared asset, resource or service, represented by a cost that is consumed by a Service, is unlikely to be static. Accordingly, the percentage of cost allocated to a Service is also unlikely to be static. Even if the regulated Service outputs themselves are static, the levels of activity of the other Services with whom the cost is shared may not be, in which case, the percentage of shared cost attributable to the regulated Service will change.

In the Expert's view, the precedents for Principles 1, 5 and 6 which seek causal allocations which report the substance of transactions and do not prescribe allocators, are precedents for this principle, for the reasons set out above.

While Principles 5, 6 and 8 do not necessarily have a practical application when the allocation of cost for single year is being considered, this has no bearing on the validity of any other individual principles or the body of principles as a whole. Principles 5, 6 and 8 are stated here to provide a complete, general framework.

The expert report, *KPMG, The key principles underlying regulatory cost allocations, 17 April 2014,* also describes these Generally Accepted Principles and supporting precedents as being appropriate to an objective of fairly stating attribution of expenditure to services.

E.2 The ACCC's cost allocation fixed principles

The Expert has also referred to the cost allocation fixed principles, set by the ACCC in the 2011 FLS FADs and in its Draft Decision[7]. On this basis, the Expert considers that the cost allocation fixed principles provide an appropriate basis for attributing expenditure to FLS.

These principles are:

6.14 Cost allocation factors

(a) *The allocation of the costs of operating the PSTN should reflect the relative usage of the network by various services.*

(b) *Direct costs should be attributed to the service to which they relate.*

The cost allocation factors for shared costs should reflect causal relationships between supplying services and incurring costs.

[7] The ACCC did update the fixed principles in the 2013 Wholesale ADSL FAD but those updates did not impinge on the FAD allocation fixed principles, which do not vary between the 2011 fixed line services FADs and the 2015 draft decision.

(c) *No cost should be allocated more than once to any service*

(d) *The determination of cost allocation factors should reflect the principles in 6.14 (a) – (c) above except where reliable information is not available to support the application of the principles;* [8][9]

The following table compares the Cost Allocation Fixed Principles to the Generally Accepted principles, to help assess whether this is the case.

Table E - 1: Consistency of Cost Allocation Fixed Principles and Generally Accepted Principles

Cost Allocation Fixed Principle	**Corresponding Generally Accepted Principle**[10]
(a) The allocation of the costs of operating the PSTN should reflect the relative usage of the network by various services.	*Principle 1: Allocators should reflect a cause and effect relationship wherever possible.* *Principle 3: Allocations of cost must be capable of reconciliation to the total cost being allocated.* While Cost Allocation Fixed Principle (a) does not explicitly state Principle 3, the Cost Allocation Fixed Principle requirement for relative usage requires Principle 3.
(b) Direct costs should be attributed to the service to which they relate. *The cost allocation factors for shared costs should reflect causal relationships between supplying services and incurring costs.*	*Principle 1: Allocators should reflect a cause and effect relationship wherever possible.* The Cost Allocation Fixed Principle is not explicit about this requirement in that it does not define or explain the terms "direct cost" or "attributed". Nonetheless, this requirement is consistent with the Expert's knowledge of precedents and Principle 1 above. In particular: *"The use of causal allocation is also consistent with the concept that some costs may be wholly or directly attributable to a service. Costs are necessarily subject to a cause, cost driver or trigger, it is just that where costs are directly attributable to a service, the service wholly accounts for the cost driver. Therefore, the distinction between:* • *a wholly or directly attributable cost;* • *an allocated cost; and* • *a cost that is not allocated at all to a service* *is one of degree only. In each case, the service accounts for:* • *all;*

[8] ACCC, Final Access Determinations No. 1 to No. 6, 20 July 2011, as varied 14 December 2011, pp. 6-7.
[9] ACCC. Public inquiry into final access determinations for fixed line services- primary price terms, Draft decision, March 2015, p. 219.
[10] [10] KPMG, 14 April 2014, The key principles underlying regulatory cost allocations, pp. 3-5.

Cost Allocation Fixed Principle	**Corresponding Generally Accepted Principle**[10]
	• *some; or* • *none* *of the causal driver, and hence allocator, of the cost respectively."*[11]
c) No cost should be allocated more than once to any service	*Principle 2: Allocations of cost between services need to be on mutually consistent bases.* Principle 2 is consistent with Principle 3. The description of Principle 2 describes how it has an objective of ensuring both that a cost is completely allocated and that the total of the allocated costs do not exceed the total of the shared cost subject to allocation. *Principle 3: Allocations of cost must be capable of reconciliation to the total cost being allocated.* If a cost were allocated more than once, Principle 3 would be violated.
(d) The determination of cost allocation factors should reflect the principles in 6.14 (a) – (c) above except where reliable information is not available to support the application of the principles.	*Principle 1: Allocators should reflect a cause and effect relationship wherever practical.* In some instances, it may not be practicable to precisely identify and measure causal allocators of cost. In such cases, it may be necessary to substitute a close approximation to an ideal causal allocator, to provide allocations that do not differ significantly from a causal allocation. Regulatory frameworks including the National Electricity Rules for example[12], recognise this. This matter is dealt with by Principle 4. *Principle 4: Cost allocators need to be practical.* In this regard, the Generally Accepted Principles go beyond the Cost Allocation Fixed Principle, because unlike the Cost Allocation Fixed Principles, Generally Accepted Principles 1 and 4 provide reasoned guidance on how to conduct allocations where information may not be available, such as that which would allow causal allocations.

Accordingly, the Cost Allocation Fixed Principles and the Generally Accepted Principles are mutually consistent.

In addition, in the Expert's view, there are no characteristics of the Cost Allocation Fixed Principles and Generally Accepted Principles that are mutually inconsistent. Generally Accepted Principles 5, 6, 7 and 8 set out matters on which the Cost

[11] Ibid at p. 9.
[12] Australian Energy Market Commission, National Electricity Rules, Clause 6.15.2 (3) (ii).

Allocation Fixed Principles are silent. In the Expert's view, these particular Generally Accepted Principles provide additional guidance on cost allocation matters that are encompassed by the Cost Allocation Fixed Principles. They do not lead to cost allocations that would be inconsistent with or contradictory to, the FAD principles.

APPENDICES F-O REDACTED