Review of WIK report to ACCC—FINAL report

Mike Smart

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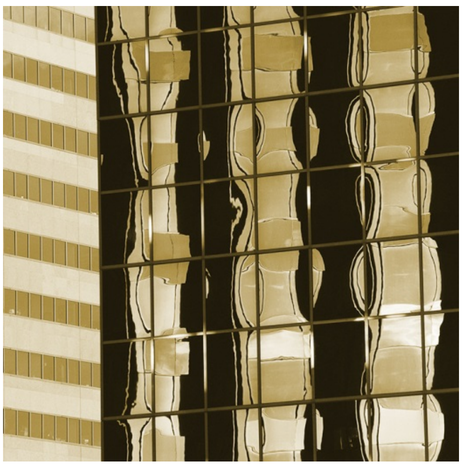

About the Author

Mike Smart is a director of Sapere Research Group in Sydney. He advises industry leaders in telecommunications, rail, gas, logistics, mining, electricity and aviation. Mike has given expert evidence in the Federal Court of Australia and the Australian Competition Tribunal. He is a member of the Competition and Consumer Committee of the Law Council of Australia and the Economics Society of Australia.

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Sapere Research Group is one of the largest expert consulting firms in Australasia and a leader in provision of independent economic, forensic accounting and public policy services. Sapere provides independent expert testimony, strategic advisory services, data analytics and other advice to Australasia's private sector corporate clients, major law firms, government agencies, and regulatory bodies.

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Summary

My name is Michael Smart. I am a consulting director of the Sapere Research Group in Sydney. I have extensive experience in the economics of regulated telecommunications networks. The details of my background and experience can be found in my curriculum vitae, which was attachment 1 to my earlier report ("*Review of Telstra's fixed services forecast model*," 7 October 2014).

I have been asked by Gilbert + Tobin, acting for Telstra Corporation Ltd, to undertake an expert review of a report prepared by WIK Consult for the ACCC entitled, "*Assessment on the efficiency and prudency of Telstra's expenditure forecasts,*" 5 March 2015. This report sets out the findings from my review of the WIK report. A copy of my instruction letter is attachment 1.

My earlier report consisted of a critical analysis of Telstra's Fixed Services Forecast Model and associated documentation. In summary, my findings in that report were that the assumptions are reasonable, if not conservative in the sense that some types of costs in future years may tend to be understated by the model. I also found that the choice of algorithms is appropriate for those assumptions, and the spreadsheet logic faithfully implements those algorithms. None of my earlier opinions have changed as a result of reading the WIK report. It continues to be my view that Telstra's expenditure forecasts were prepared on the basis of reasonable assumptions, appropriate choice of algorithms to implement those assumptions, and correct transcription of those algorithms in the spreadsheet model.

This report begins with a summary of WIK's main conclusions. The body of this report then analyses WIK's conclusions and the logic underpinning them. In brief, my opinion is that WIK has failed to establish any mistakes in the quantitative data previously submitted to the ACCC by Telstra. Consequently, WIK's recommendation for a price freeze for declared fixed line services is ill-founded and incorrect in economics. The consequences of adoption of WIK's recommendations would be a distortion to future competition between providers of retail services that rely on declared fixed line inputs and providers of retail services that rely on other non-declared inputs.

In preparing this report, I have had regard to the Guidelines for Expert Witnesses in the Federal Court of Australia. I confirm that I have made all the inquiries that I believe are desirable and appropriate. No matters of significance that I regard as relevant have, to my knowledge, been withheld from my report.

1 Summary of WIK's conclusions

WIK claims, in its executive summary and in s9.2 at the end, that it has identified "faults and deficiencies" in Telstra's expenditure forecast model. There are four types of matters that WIK's executive summary identifies as problematic:

A. Telstra's allocation of excess capacity in ducts and building space to declared fixed line services is said to be inappropriate (see pars. 7,8,26);
B. There is said to be insufficient granularity in asset data provided by Telstra (see pars. 4,13,14,17,18-21,23);
C. PROPEX is expensed rather than capitalised, which is said to be the appropriate accounting treatment (see pars. 12,28); and
D. NBN-related CAPEX is said to have been allocated to declared fixed line services inappropriately (see pars. 24,29).

Owing to these claimed mistakes in Telstra's price justification, WIK states (par. 31) that its findings are more compatible with a price decrease than a price increase. However, WIK does not quantify this effect, instead recommending a price freeze for declared fixed line services.

2 WIK deliverables

Before directly examining WIK's conclusions, it is worth pointing out that WIK has not fulfilled its mandate, but has instead opined on a range of matters that sit outside its scope.

2.1 Brief not fulfilled

WIK was engaged to assess the efficiency and prudency of Telstra's expenditure forecasts. They have not done that. They state (par. 31) that "*Our findings regarding the prudency and efficiency of Telstra's forecast expenditure are less compatible with a price increase but more with a price decrease, without being able to quantify the exact amount of a necessary price decrease.*" In fact, their analysis does not even provide a satisfactory basis on which to determine the direction in which prices should move. Reflecting this point, WIK proposes a price freeze (par. 31).

2.2 Strayed beyond brief

WIK has reached conclusions on several matters that lie outside their brief:

- (par. 349) WIK proposes that Telstra "disposes" of assets, such as underutilised rack space and exchange building capacity, even where these are not sold or leased to NBN.
- (par. 360) WIK proposes to reduce declared fixed line service prices by 10% after two years for the remaining part of the regulatory period if Telstra fails to provide its forecast in a particular format. A punitive charge of this sort for regulatory reporting non-compliance is inconsistent with the principle of cost-reflective pricing, and the suggested quantum is arbitrary.
- (par. 363) WIK concludes (speciously, in my view) that 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. This conclusion misconstrues the relevant

LTIE test (in which the concept of producer surplus does not appear), and blurs the distinction between producer surplus on regulated and unregulated services.

- (pars 375 – 378) WIK recommends that the ACCC, in essence, designs its own fixed services forecast model for future use.

3 No substantive adverse findings

WIK's report is notable for its lack of specific quantitative findings, given that its subject matter—regulatory pricing—is inherently quantitative. Instead, it contains many qualitative judgements that lack empirical foundation or that dismiss quantitative information submitted by Telstra that supports opposite conclusions. Despite claims that Telstra's submissions contain "faults and deficiencies" WIK's report does not establish that any mistakes have been made by Telstra. Therefore, WIK was incorrect to recommend a price freeze instead of the specific pricing proposals put forward by Telstra.

3.1 Absence of quantitative conclusions

WIK suggests that Telstra's expenditure forecasts are not prudent or efficient, since it recommends against the price increases proposed by Telstra. However, WIK does not present any alternative calculation of efficient and prudent expenditure and the effect that would have on pricing. This is unsatisfactory because regulatory expenditure proposals should be able to be tested in a practical sense before they are imposed on the regulated firm. WIK's price freeze proposal contains an implicit expenditure proposal, but it is not articulated so its realism cannot be tested. Specifically, there is no way to know whether this implicit expenditure proposal respects real-world constraints imposed by the indivisibility of certain types of assets and the obligation to provide declared services. If, as I show in section 5 below, it does not respect these constraints, then it is not a plausible alternative. WIK's implicit expenditure proposal is not something that a prudent and efficient firm acting in a pro-competitive manner but faced with the same constraints could possibly do.

3.2 Lack of evidence for WIK assertions

Simply put, WIK has not done the analysis that it was asked to do. Consequently it is forced to guess that regulated prices should be lower. Clearly it is not confident in that guess as it has recommended a price freeze. Instead of evidence, WIK has resorted to supposition in order to support its claim that forecast expenditure is not efficient. For example, WIK devotes s3.2.2 to a discussion of the double-recovery of costs, saying that (par. 110) the risk of double-recovery of costs is high. Further, WIK devotes s3.2.4 to a discussion of Telstra's incentives to distort expenditure allocations, stating (par. 115) that *"For this reason we want to specify in the following paragraphs how such incentives might work and how they might distort "true" values."* Notwithstanding the various hypotheticals raised in that section, no evidence is presented to support a claim of double-recovery of costs or of distorted expenditure allocations.

3.3 No mistakes in Telstra submissions established by WIK

Telstra made its fixed services forecast model available to the ACCC and to WIK, together with extensive documentation and a critical review that was performed by me. The workings of that model and all input data were made transparent to the ACCC and WIK. No mistakes in this model or in the approach have been established by WIK. Procedurally it is unusual to refuse to accept a price forecast in which no mistakes have been established and instead to adopt a price recommendation that has no basis whatsoever in quantitative analysis or empirical fact.

WIK does indeed claim, in its executive summary and in s9.2 at the end, that it has identified "faults and deficiencies" in Telstra's expenditure forecast model. However, there are really only four types of matters that WIK's executive summary identifies as problematic:

A. Telstra's allocation of excess capacity in ducts and building space to FLS (see pars. 7,8,26);
B. Insufficient granularity in asset data provided by Telstra (see pars. 4,13,14,17,18-21,23);
C. PROPEX is expensed rather than capitalised (see pars. 12,28); and
D. NBN-related CAPEX is said to have been allocated to FLS inappropriately (see pars. 24,29).

Concerning matters of type A, the attribution of excess capacity costs, it is WIK that has made the mistake, in my view. My reasons are set out below in sections 5.2, 5.3 (existence of scale diseconomies) and 6 (who should bear them).

Concerning matters of type B, WIK's expectations of reporting detail are unrealistic, as explained in section 4 below.

Concerning matters of type C, a close reading of Telstra's accounting policy for recognition of asset costs as capital or opex shows that the principle followed by Telstra is the same principle as that espoused by WIK: capitalised costs are only those that are directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. Costs that do not meet that test (i.e., PROPEX) are expensed. This issue is explained in detail in section 8 below.

Concerning matters of type D, the issue is analogous to that raised by type A matters: the Government's decision to roll out the NBN has led to certain costs of providing FLS (in this case remediation of NBN-caused damage). WIK is incorrect in economics in asserting that Telstra alone should bear these costs, as set out in more detail in section 7 below.

In summary, the claimed faults and deficiencies have not been established as mistakes. Rather these claims reflect errors of economic analysis, a misunderstanding of the statutory constraints that affect Telstra, and unrealistic expectations on WIK's part.

4 Impractical approach

WIK complains (notably in s2.6 and s5.8) about the lack of information provided on physical quantities of assets, about the lack of granularity in asset information, and about the lack of data that would permit WIK to estimate Asset-Volume Relationships ("AVRs") and Cost-Volume Relationships ("CVRs").

It is true that Telstra did not provide physical asset information at the level of detail that WIK would prefer. This information would be extremely detailed and complex. For example, (par. 249) WIK states that a list of cost centres has to be prepared (to derive CVRs and AVRs), and (par. 251) WIK says that a separate primary cost centre would be required for each copper loop cable, each MDF, each DSLAM, and every piece of transmission or switching equipment. In a service area containing more than 10 million SIOs the proposed number of cost centres would be unmanageably large. This proposed bookkeeping structure would be very costly to manage in an accounting sense, but also disproportionately detailed for the task of benchmarking AVRs and CVRs.

The apparent intention to benchmark AVRs and CVRs is also fraught with comparability challenges. Population and traffic densities in Australia are vastly different from those in Europe, where WIK's knowledge base is presumably founded (being a German firm).

5 Constraints not respected by WIK

Telstra is, of course, constrained by accounting conventions, by the indivisibility of certain assets used to produce telecommunications services, and by the declaration of certain fixed line and other services that it provides. Any realistic appraisal of what a prudent and efficient firm would do must respect the fact that the firm is subject to these constraints, but WIK's appraisal does not.

5.1 NBN-affected assets – disposal versus depreciation

In an accounting view, asset disposal occurs only when the rights and liabilities associated with an asset are transferred from one party to another, which usually occurs through a sale transaction.

WIK claims, at many places in its report, that Telstra assets that are becoming affected by reduced utilisation should be "disposed". Such an approach would be in conflict with accounting conventions as these assets are not transferred to another party. I note that this view has been put in the following terms by Keith Lockey of KPMG in his report (p. 4):

> "*the ACCC's classifications of decommissioned assets and assets utilised to a lesser extent, as asset disposals as a consequence of the assets being decommissioned or utilised to a lesser extent, are inconsistent with Accounting Standards.*"

Moreover, the liabilities attached to certain assets that are used to provide declared fixed services (i.e., the obligation to provide service at a price that may fail to recover cost) cannot be extinguished by the owner.

Instead of "disposing" of these NBN-affected assets, the impairment to their value should be recognised as a depreciation charge in the profit and loss account. Where this impairment is the result of events beyond Telstra's ability to predict or control (such as decisions imposed on the owner by Government), this depreciation charge should form part of the regulatory revenue requirement. Also, "disposal" of the kind favoured by WIK is inconsistent with the fixed principles concerning asset valuation.

5.2 Failure to understand constraints posed by indivisible assets

WIK states that it is inappropriate to allocate excess asset capacity to declared fixed line services (par. 87). Two reasons are given. First, WIK denies that falling utilisation of the copper CAN necessarily leads to increasing average costs. Second, WIK asserts that any such increase in average costs that may occur should not be borne by access seekers because they did not cause the increase. In my view, both of these reasons are invalid. I analyse the first reason in this section. My analysis of the second reason is presented in section 6 below.

WIK's assertion that average costs should not increase is founded on its mistaken belief that the relevant assets are completely scalable to deal with fluctuations in demand. In essence, WIK denies the existence of fixed costs. WIK states (par. 87) that "*To a relevant degree Telstra has the option to sell unutilised building space, e.g. by downsizing of the corresponding buildings. Or Telstra has the option to use this capacity for non-telecommunications purposes.*"

In evaluating this claim, I have had regard to the statement o [redacted]

[redacted]

As [redacted] statement makes clear, the space at an exchange that is freed by declining utilisation may not be contiguous, hence would not readily (i.e., without significant expense) be configurable into a marketable package.

These points are all reflected in the Telstra fixed services forecast modelling work. However, these facts contradict the assertions by WIK to the effect that scale diseconomies reflect imprudence or inefficiency on Telstra's part. Clearly, scale diseconomies would be experienced by a prudent and efficient service provider standing in Telstra's place.

5.3 Failure to acknowledge constraints posed by declaration of relevant services

In paragraphs 362-374, WIK argues that the denial of price increases would not do economic harm to Telstra. This surprising conclusion is reached through the following steps:

1) economic costs, rather than historic costs, are relevant to this analysis;
2) average economic costs of providing fixed services are falling over time;

3) technological improvements mean that the total cost curve is declining over time;
4) utilisation should be measured on the basis of the summation of FLS provided on legacy networks and substitutes for FLS that may be provided on different networks;
5) on this basis, utilisation is increasing, not falling;
6) as a result, a denial of price increases would do no economic harm to Telstra, since its average economic costs are falling and will continue to do so.

At several steps in this argument WIK appears not to understand the full implications of the declaration of the relevant fixed line services.

The argument for step 1), that economic rather than historic costs are relevant (par. 362), relies on the notion that "*If expected revenues are below economic costs, the concerned undertaking will have to leave the market*." This argument ignores the fact that Telstra is unable to leave the market for declared services, even when expected revenues are below economic costs.

Steps 2) – 5) are founded on the mistaken belief that the fixed line service declarations are technology neutral. For example, (par. 366) despite the fact that Telstra is legislatively and contractually prevented from putting its own fibre loops into the ground, *"fibre loops are still the MEA that is relevant to the valuation of Telstra's remaining copper loops and related ducts."*[1]

(Par. 370) Because a SSNIP test would identify some retail FLS products provided on state of the art Ethernet-based NGN and fibre loops as substitutes for retail FLS provided on legacy networks, "*it is thus fair to say that fibre loops are MEA in relation to copper loops. The OPEX that is attributable to the substitutes of FLS is smaller than the OPEX of the legacy networks*."

WIK states (Par. 373) that the procedure of defining service volumes for determining average cost on the basis of distinct technology is flawed. "*However, it is not technology that defines relevant service volumes, but the substitutability of services according to the SSNIP-test*."

In each of these statements, WIK has ignored the fact that declaration of the fixed line services at issue here obliges Telstra to make certain specific wholesale services available to access seekers using specifically mandated technology. The ACCC's March 2015 Draft Decision sets out the description of the declared FLS in its Appendix E, which notes the following points:

- The ULLS "*is the use of unconditioned communications wire*";
- The Line Sharing Service "*is the use of the non-voiceband frequency spectrum of unconditioned communications wire*";
- WLR "*is a line rental telephone service*" which allows an end-user to connect to a carrier's PSTN;
- LCS and fixed OTAS are somewhat more broadly defined;

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[1] This conclusion by WIK is based on the assumption that "*Compared to a hypothetical situation in which Telstra would be free to put its own fibre in the ground, the deal with NBN Co does not put Telstra in an economic* [sic] *worse position.*" (par. 366) [redacted] statement (par. 23(b)) shows that assumption to be incorrect.

- WADSL is defined so that it must be supplied using ADSL technology over a twisted metallic pair, and using a static layer 2 tunnelling protocol.

In light of the constraints imposed by declaration, fibre loops are not acceptable substitutes for the copper CAN for delivery of these declared services. Therefore, WIK's arguments about declining economic costs and increasing utilisation are mistaken. WIK's conclusion that a denial of price increases would do no economic harm to Telstra (or a prudent and efficient firm standing in its place) is incorrect.

6 Mistaken analysis of NBN transition

WIK states in many places (notably s5.2.3.2, par. 81, par. 169, par. 294, and par. 311) that FLS customers should not bear the increasing average costs that result from reduced utilisation of fixed cost assets. It is inconsistent on one hand to force an asset owner to share scale economies with customers but on the other hand to expect the owner to bear scale dis-economies alone. Beyond this, the position WIK espouses reveals an incorrect and incomplete economic analysis of the NBN transition period.

It is inevitable that for a period of several years the partially-completed NBN will co-exist with legacy CAN assets. The statement of [redacted] sets out the reasons why this period of asset duplication will be prolonged. The capacity of physical plant to meet the required demand for fixed services will be excessive over that time frame. This excess capacity does not reflect inefficient provision of infrastructure. Rather it is an unavoidable result of the Commonwealth Government's decision to build the NBN. The length of time over which duplication will be a problem has been increased by decisions taken by the Commonwealth that have led to coordination issues between NBN and Telstra. [redacted]).

The access seekers who buy declared fixed line services from Telstra did not initiate the NBN. Neither did Telstra. Neither party made any commercial decision that resulted in this transitional overcapacity. The statement of [redacted] makes clear (par. 23 (b)) that Telstra would have been better off commercially had the NBN never been built. The Government's decision to go ahead with the NBN forced Telstra to decide between two options: cooperate with the NBN or compete with it. Both options involved a loss of shareholder value to Telstra, even when the payments under the Definitive Agreements are taken into account.

6.1 WIK approach inconsistent with s152BCA(1)

To insist that access seekers bear no NBN-related scale diseconomy costs because they didn't <u>cause</u> the diseconomy is to prioritise s152BCA(1)(c) over s152BCA(1)(b) of the Competition and Consumer Act 2010 ("CCA").

S152BCA(1)(c) requires the ACCC, in making an access determination, to take into account the interests of all persons who have rights to use the declared service. WIK focuses on this provision in its recommendations.

S152BCA(1)(b) requires the ACCC to take into account the legitimate business interest of a carrier who supplies the declared service and the carrier's investment in facilities used to supply the service. WIK ignores this provision in its recommendations.

By precisely the same logic as WIK applies in par. 311, Telstra should not bear NBN-related scale diseconomy costs because Telstra didn't cause them, either.

A position that balanced the two subsections of the CCA (as the ACCC is required to do) would involve partial sharing of the NBN-related diseconomy costs by Telstra and access seekers. Such a sharing would result from the pricing proposals put forward by Telstra in their submissions to the ACCC.

6.2 Competitive neutrality problems with WIK proposal

The technical appendix below provides mathematical proofs of the proposition that WIK's proposal of a price freeze for declared fixed line services would, in the circumstances of lost scale economies due to NBN migration, create a new source of competitive disadvantage for some industry players. Under the WIK pricing recommendation, providers of downstream services that rely on declared fixed line services would obtain a new cost advantage over competing providers of downstream services that rely on fixed line inputs that are not declared.

The appendix also shows that the quantum of this cost advantage for access seekers would be increased if the ACCC were to act on WIK's suggestions that declared prices be reduced.

Contrary to WIK's assertions (par. 94), the existence of payments from NBN Co to Telstra under the Definitive Agreements, does not compensate Telstra for the consequences of the price freeze on declared services. In fact, these payments together with the additional net costs imposed on Telstra by the Agreements serve to heighten the extent of the access seeker cost advantage. This proposition is also proven in the appendix.

7 Who pays for NBN cost impacts on existing networks?

As noted in section 6 above, a period of overcapacity was implicit in the Government's decision to build the NBN. This decision therefore impacted on the utilisation of legacy fixed line assets. Also implicit in the decision to build the NBN was the imposition of a new type of cost on the legacy fixed line assets. This cost type is the result of the use of legacy assets (esp. ducts) by the NBN.

I have already argued that the utilisation impacts of the NBN should be shared between Telstra's customers of declared services and non-declared services in proportion to their relative usage. The same argument applies to the cost impacts of the NBN.

Whether average costs increase because of falling utilisation, increases to some categories of cost, or both effects, the competitively neutral wholesale price will rise. If one class of wholesale customer is permitted to escape these consequences, then the remaining customer classes will experience a new competitive disadvantage that would be imposed, ironically, by regulatory decisions.

8 Capitalisation of PROPEX

Section 4.1 of the WIK report sets out WIK's opinions on the appropriateness of expensing PROPEX. WIK makes the following statements (taken from p. 36):

i. If an expense can be saved by refraining from commissioning the asset in the first place, the expense is CAPEX (par. 136);
ii. If the expense serves to extend the economic lifetime of an asset ("asset remediation"), the expense is CAPEX (par. 136);
iii. The expenditure to which Telstra refers as "PROPEX" is in fact CAPEX (par. 138).

In my view, statement i is true of expenses incurred at the time of asset acquisition, statement ii may be true, depending on the materiality of the lifetime extension relative to other purposes of the expense, but statement iii is incorrect so long as Telstra follows its own accounting policies on asset recognition.

Concerning statement i, expenses relating to the commissioning of the asset that are avoidable in the case of non-commissioning are clearly CAPEX. This statement is, however, imprecise. Future expenditures incurred in the maintenance and operation of a new asset could be saved if the asset had not been commissioned, but these are clearly OPEX, not CAPEX. WIK's statement, while well-intentioned, is too broad.

Concerning statement ii, it must be recognised that some maintenance or operational expenditures might have some minor impact on the asset's life. Whether these expenses should be capitalised depends on the materiality of the lifetime extension effect compared to the purely operational impacts of the expenditure. Again, WIK's statement is too broad.

Concerning statement iii, I refer to Telstra's Corporate Accounting Policy [redacted]. On page 3, this document sets out the policy statement that underpins it:

[redacted]

[redacted]

This test for asset recognition (i.e., capitalisation) is further amplified in other Telstra accounting policy documents. For example, a necessity of cost test is set out [redacted]:

[redacted]

This necessity of cost test is virtually identical to WIK's statement i.

In my opinion, the phrases '*costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management*' and '*costs that can be saved by refraining from commissioning the asset in the first place*' mean the same thing, apart from the ambiguity in WIK's formulation that I noted above.

Therefore, I conclude that there is no practical difference between the test that WIK proposes (apart from the imprecise language that they use) and the test in Telstra's accounting policy. WIK's claim iii would only be correct in the unlikely event that Telstra did not follow its own accounting policy with respect to the PROPEX forecasts in its FLSM.

9 Fixed principles not respected

Throughout chapter 5, WIK complains that Telstra's base year values for various expenditure categories are hard-coded inputs to the Forecast Model. For example, (par. 154) WIK says that due to this hard-coding, "*It is not possible to assess whether these figures are prudent and efficient.*"

As I noted in my previous report,[2] the base year expenditure figures are actual results as recorded in Telstra's accounts. I note that the KPMG report concludes, inter alia, the following in support of this point:

> *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.*

There are many reasons to believe, ex ante, that Telstra's actual expenditures are prudent and efficient. Most inputs are acquired by Telstra on competitive markets. Many of the products and services supported by these inputs are sold on competitive markets with a high degree of price elasticity. Finally, Telstra is a public company whose shareholders hold management accountable for efficient performance.

WIK's objection to the use of prior year actual expenditures is at odds with the Fixed Principles, which note that "*in assessing the reasonableness of Telstra's operating expenditure forecasts, the ACCC will take into account: the access provider's level of operating expenditure in the previous regulatory period …*"[3]

Elsewhere, WIK objects (par. 375) to the separation Telstra makes between operating expenditure and capital expenditure in the base year, implying that this separation creates

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2 "*Review of Telstra's fixed services forecast model—Draft report,*" Mike Smart, 7 Oct 2014, submitted to the ACCC by Telstra.

3 ACCC (July 2011). Inquiry to make final access determinations for the declared fixed line services, Final Report, p. 131.

opportunities for distortions. However, the Fixed Principles also require that "*in assessing the reasonableness of Telstra's capital expenditure forecasts, the ACCC will take into account: the access provider's level of capital expenditure in the previous regulatory period …*"[4]

In other words, the presentation of base year values by Telstra, of which WIK complains, is actually dictated by the Fixed Principles.

10 Conclusions

This report analyses WIK's recommendations and the logic underpinning them. In brief, my opinion is that WIK has failed to establish any mistakes in the quantitative data previously submitted to the ACCC by Telstra. Consequently, WIK's recommendation for a price freeze for declared fixed line services is ill-founded and incorrect in economics.

The consequences of adoption of WIK's recommendations would be a distortion to future competition between providers of retail services that rely on declared fixed line inputs and providers of retail services that rely on other non-declared inputs.

None of the conclusions of my earlier report have changed as a result of reading the WIK report.

4 Ibid.

11 Technical appendix

This appendix provides the mathematical proofs for many of the propositions that are made in the body of this report. These propositions are as follows:

- the decision to build the NBN will cause average costs of providing fixed line services to rise because, while costs will fall, they will not do so as quickly as utilisation;
- the average cost represents the competitively neutral price as between declared and non-declared FLS and the downstream services that rely on each of them;
- WIK's proposed price freeze for declared FLS will cause:
  - the price for declared FLS to fall below the competitively neutral price;
  - the break-even price for non-declared FLS to rise above the competitively neutral price; and, therefore,
  - a distortion to competition between declared and non-declared FLS and the downstream services that rely on each of them;
- WIK's suggestion that declared FLS prices be reduced from current levels by:
  - excluding from the cost base those costs caused by the NBN rollout; and
  - basing declared FLS prices on pre-NBN utilisation patterns;

  will cause an even greater distortion to competition than the price freeze proposal;

- The existence of NBN payments to Telstra as part of the Definitive Agreements, together with the additional costs imposed on Telstra by the NBN serves to increase the competitively neutral prices and Telstra's breakeven prices, not reduce them as WIK asserted.

Consider first the annualised costs of assets and activities undertaken by Telstra that are common to the declared fixed line services, non-declared fixed line services, and other downstream services that use fixed line inputs. Let C represent those costs that were incurred pre-NBN, and let C' represent those costs that are incurred while the NBN rollout is taking place.

Let D be the usage of common assets by declared fixed line services pre-NBN and let D' be the usage with NBN. Let N be the usage of common assets by non-declared fixed line services and downstream services that have fixed line inputs pre-NBN and let N' be the usage with NBN.

Let Pd be the average price for declared fixed line services and Pn be the average price for non-declared fixed line services (and the input unit cost for downstream services using fixed line services) in the pre-NBN situation. Pd' and Pn' are the equivalent average prices with NBN.

Clearly Pd is set by the ACCC. The break-even level of Pn for Telstra is given by equation (1):

$$Pd*D + Pn*N = C \quad (1)$$

If regulated wholesale pricing is to be competitively neutral, then Pd = Pn = P, where

$$P = C / (D + N) \qquad (2)$$

This is necessarily the case because the retail services sold by seekers of declared fixed line access compete with Telstra's own retail services. A situation where $Pd > P > Pn$ would artificially disadvantage access seekers, and the converse situation where $Pd < P < Pn$ would artificially disadvantage either Telstra or its retail customers.

Pricing in the with-NBN world is complicated somewhat by the fact that the decision to build the NBN imposed new net costs on Telstra, which we will denote by Z. The definitive agreements between Telstra and NBN Co involve payments to Telstra which we denote by X. The break-even pricing equation in the world with NBN is given by equation (3):

$$Pd'^*D' + Pn'^*N' = C' + Z - X \quad (3)$$

I note that according to the statement of [redacted] (par. 23 (b)), the payments that had been proposed as part of the $11 billion package of commercial arrangements with NBN Co and the Government under the heads of agreement were not sufficient to fully address this anticipated lost value associated with the rollout of the NBN. I interpret this statement to mean that $Z > X$, so that $Z–X > 0$.

The competitive neutrality condition for wholesale pricing with NBN is that $Pd' = Pn' = P'$, where

$$P' = (C' + Z - X)/(D' + N') \quad (4)$$

As was noted in Telstra's forecast model and documentation, fixed line costs decline less than in proportion to fixed line usage as the NBN is rolled out. This means that:

$$C'/C > (D' + N')/(D + N) \quad (5)$$

Rearranging equation (5) and using equations (2) and (4), we see therefore that:

$$P' > C'/(D' + N') > C/(D + N) = P \quad (6)$$

Equation (6) simply states that if the with-NBN pricing were done on the basis suggested by Telstra then prices would increase for declared and non-declared services.

WIK's recommendation for a price freeze, i.e., $Pd' = P$, would violate the competitive neutrality principle. The proposed new declared services pricing would be below the competitively neutral price level, and therefore the break-even price for non-declared services would be above the competitively neutral level. This can be seen clearly by combining equations (3) and (4) and rearranging terms:

$$Pn' = (C' + Z - X - D'P)/N' = P' + D'(P' - P)/N' \quad (7)$$

We know that $P' > P$, so the second term of the right hand side of equation (7) is positive. Therefore, $Pn' > P' > P = Pd'$.

These pricing relations represent an artificial and unwarranted price advantage to access seekers in the with-NBN world. On this basis, WIK's price recommendation would harm competition between access seekers who rely on fixed line inputs and providers of retail services that do not.

WIK also indicates (pars. 293-294) that its preference is to base declared fixed line service prices on two modifications to the price freeze approach:

- Post-NBN costs should be allocated to declared services on the basis of pre-NBN usage of the common assets (i.e., actual scale diseconomies should be ignored); and
- Costs imposed by the NBN rollout on the legacy networks should be removed from the post-NBN cost base that is so allocated.

These modifications, singly and in combination, would mean that Pd' < P. The detailed analysis of this case is not needed to see that such a proposal would only exacerbate the competitive neutrality problem that would be caused by the price freeze proposal. An even larger portion of the cost base would need to be recovered from the non-declared services.

WIK (at par. 94) attempts to make a case that the NBN payments provide Telstra with a net advantage that should be passed on to access seekers. WIK's logic appears to be as follows.

1) Telstra is a net beneficiary of the NBN Co definitive agreements (implying that X > Z) because, if it was not, then Telstra would not have agreed to these arrangements.
2) Telstra's commercial decision concerning the NBN was (according to WIK) based on the choice that would maximise outcomes:

   Value of deal = max(X – Z, 0).

3) Since the outcome X – Z was chosen, then X – Z > 0.

WIK says (par. 366), "*at the time when Telstra concluded the deal with NBN Co, Telstra did not suffer an economic loss; otherwise Telstra would not have concluded the deal.*"

This analysis is flawed because WIK has misconstrued the choices actually open to Telstra. As [redacted] statement makes clear, the choices were either to cooperate with the NBN or compete with it. There was no option available that would allow Telstra to prevent the NBN from going ahead. Cooperation would involve a deal value of $X - Z_{cooperate}$. Competition would involve a deal value of $-Z_{compete}$. In the compete option, there would be no payments from NBN Co. Thus, the true value of the NBN deal was:

$$\text{Value of deal} = \max(X - Z_{cooperate}, -Z_{compete})$$

According to [redacted] statement, both outcomes are negative, but X – Z less so. Telstra concluded a deal under which it suffered an economic loss because it was the best deal available.

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29 April 2015

By email

Mike Smart
Director
Sapere Research Group
Email msmart@srgexpert.com

Confidential and privileged

Dear Mike

ACCC review of prices for Telstra declared fixed line services

We refer to our letter of engagement dated 30 September 2014 in relation to the above matter, and your report dated 7 October 2014 (**Previous Report**).

On 11 March 2015, the ACCC published a draft decision on primary price terms for the declared fixed line services. The draft decision relied in part on a report from Wik-Consult in relation to the prudency and efficiency of Telstra's expenditure forecasts.[1]

We would like you to review the Wik-Consult report for the ACCC, and prepare a report setting out your expert opinion on the following matters:

1 whether you agree with the conclusions of Wik-Consult in relation to the prudency and efficiency of Telstra's expenditure forecasts; and

2 whether any of the opinions expressed in your Previous Report have changed, in light of the Wik-Consult report or any of other evidence you have reviewed since preparing your Previous Report.

For the purposes of preparing your report we will provide you with:

- the Wik-Consult report
- the statements of [redacted] and [redacted], which relates to certain factual matters raised by Wik-Consult;
- an expert report by KPMG in relation to the meaning of 'asset disposal' under accounting standards; and
- an expert report by KPMG in relation to the process for extracting Telstra's base year operating expenditure from its accounting ledgers.

[1] Wik-Consult, *Assessment on the efficiency and prudency of Telstra's expenditure forecasts*, 5 March 2015.

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;

(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

Gilbert + Tobin

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Attachment: Federal Court guidelines for expert witnesses

Practice Note CM 7: Expert witnesses in proceedings in the Federal Court of Australia

Guidelines

1. General Duty to the Court[2]

1.1 An expert witness has an overriding duty to assist the Court on matters relevant to the expert's area of expertise.

1.2 An expert witness is not an advocate for a party even when giving testimony that is necessarily evaluative rather than inferential.

1.3 An expert witness's paramount duty is to the Court and not to the person retaining the expert.

2. The Form of the Expert's Report[3]

2.1 An expert's written report must comply with Rule 23.13 and therefore must

(a) be signed by the expert who prepared the report; and

(b) contain an acknowledgement at the beginning of the report that the expert has read, understood and complied with the Practice Note; and

(c) contain particulars of the training, study or experience by which the expert has acquired specialised knowledge; and

(d) identify the questions that the expert was asked to address; and

(e) set out separately each of the factual findings or assumptions on which the expert's opinion is based; and

(f) set out separately from the factual findings or assumptions each of the expert's opinions; and

(g) set out the reasons for each of the expert's opinions; and

(ga) contain an acknowledgment that the expert's opinions are based wholly or substantially on the specialised knowledge mentioned in paragraph (c) above[4]; and

(h) comply with the Practice Note.

2.2 At the end of the report the expert should declare that "[the expert] has made all the inquiries that [the expert] believes are desirable and appropriate and that no matters of significance that [the expert] regards as relevant have, to [the expert's] knowledge, been withheld from the Court."

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[2] The "*Ikarian Reefer*" (1993) 20 FSR 563 at 565-566.

[3] Rule 23.13.

[4] See also *Dasreef Pty Limited v Nawaf Hawchar* [2011] HCA 21.

2.3 There should be included in or attached to the report the documents and other materials that the expert has been instructed to consider.

2.4 If, after exchange of reports or at any other stage, an expert witness changes the expert's opinion, having read another expert's report or for any other reason, the change should be communicated as soon as practicable (through the party's lawyers) to each party to whom the expert witness's report has been provided and, when appropriate, to the Court[5].

2.5 If an expert's opinion is not fully researched because the expert considers that insufficient data are available, or for any other reason, this must be stated with an indication that the opinion is no more than a provisional one. Where an expert witness who has prepared a report believes that it may be incomplete or inaccurate without some qualification, that qualification must be stated in the report.

2.6 The expert should make it clear if a particular question or issue falls outside the relevant field of expertise.

2.7 Where an expert's report refers to photographs, plans, calculations, analyses, measurements, survey reports or other extrinsic matter, these must be provided to the opposite party at the same time as the exchange of reports[6].

3. Experts' Conference

3.1 If experts retained by the parties meet at the direction of the Court, it would be improper for an expert to be given, or to accept, instructions not to reach agreement. If, at a meeting directed by the Court, the experts cannot reach agreement about matters of expert opinion, they should specify their reasons for being unable to do so.

J L B ALLSOP
Chief Justice
4 June 2013

[5] The *"Ikarian Reefer"* [1993] 20 FSR 563 at 565

[6] The *"Ikarian Reefer"* [1993] 20 FSR 563 at 565-566. See also Ormrod *"Scientific Evidence in Court"* [1968] Crim LR 240