TELSTRA CORPORATION LIMITED

PRICING PRINCIPLES FOR FIXED LINE SERVICES

SUPPLEMENTARY RESPONSE TO THE ACCC'S DRAFT REPORT

November 2010

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1. INTRODUCTION

This supplementary submission relates primarily to the ACCC's cost allocation factors and aggregate demand forecasts (which were derived from those cost allocation factors). It is contributed in addition to the comments made about demand forecasting in Telstra's original submission.[1]

The ACCC's cost allocation factors were provided to Telstra approximately one week before the due date for submissions on the Draft Report. As a result, they were not discussed in detail in Telstra's earlier submission.

Demand forecasts

Telstra has a number of concerns in relation to the demand forecasts that have been adopted by the ACCC. In particular:

- the ACCC has assumed that aggregate demand for CAN lines will not decline over the four year regulatory period. This is inconsistent with generally accepted market forecasts which predict a decline in fixed line numbers;
- there is still no clear indication of what aggregate forecasts for IEN services have been adopted or used by the ACCC in its analysis; and
- the starting point for the ACCC's LCS minutes of use forecast is significantly higher than observed demand in 2009/10.

Allocators

Telstra also has a number of concerns in relation to the allocation factors used in the Ovum Building Blocks Model ("**BBM**").

In this supplementary submission, Telstra addresses only those aspects of the allocation factors in relation to which the ACCC has provided information to Telstra that is sufficient for Telstra to understand the ACCC's approach. There remain a number of aspects of the ACCC's allocation methodology where insufficient information has been made available to enable stakeholders, including Telstra, to properly understand the ACCC's approach. In relation to these aspects, Telstra would appreciate more detailed information from the ACCC so that it can properly review and comment on the ACCC's approach.

2. THE ACCC'S DEMAND FORECASTS

2.1. AGGREGATE CAN FORECASTS DO NOT REFLECT WELL ACCEPTED PSTN TRENDS

The allocator information provided to Telstra reveals that the ACCC expects aggregate demand for CAN services to remain steady (at 9,844,853 services in operation ("**SIOs**")) over the next four years.

The ACCC's forecast demand for CAN services is shown in Table 1 below.

[1] See section 5.5 of Telstra's initial response.

Table 1: ACCC forecast demand for CAN services (number of SIOs)

	2009/10	2010/11	2011/12	2012/13	2013/14
ULLS	827,333	910,066	955,570	979,459	989,253
WLR	1,252,784	1,215,200	1,196,972	1,182,011	1,170,191
Other	7,764,736	7,719,586	7,692,311	7,683,384	7,685,409
Total	**9,844,853**	**9,844,853**	**9,844,853**	**9,844,853**	**9,844,853**

The ACCC's demand forecasts for ULLS and WLR were set out in Table A8.1 of the Draft Report.[2]

Telstra has derived the ACCC's forecasts for Other (residual) and Total CAN services using the ULLS and WLR forecasts and the ACCC's allocators. The ACCC allocates the cost of ducts, pipes and copper cable assets on the basis of CAN SIOs. This means that the allocator for ULLS is equal to ULLS SIOs divided by Total CAN SIOs. Similarly, the allocator for WLR is equal to WLR SIOs divided by Total CAN SIOs. Therefore, the Total CAN SIOs can be estimated by dividing the ULLS SIOs by the ULLS allocator (or by dividing the WLR SIOs by the WLR allocator). As noted above, ULLS and WLR SIOs were set out in Table A8.1 of the Draft Report. The allocators for ULLS, WLR and Other (residual) services are set out in Table 2 below.[3]

Table 2: ACCC allocators based on proportion of SIOs

	ULLS	WLR	Other	Total
2009/2010	8.40%	12.78%	78.82%	100%
2010/2011	9.24%	12.39%	78.36%	100%
2011/2012	9.71%	12.21%	78.09%	100%
2012/2013	9.95%	12.05%	78.00%	100%
2013/2014	10.05%	11.93%	78.02%	100%

Telstra submits that it is unrealistic to assume that total demand for CAN lines will remain constant between 2009/10 and 2013/14, or indeed over shorter periods. Demand for CAN services has declined steadily in Australia and internationally over the past decade. This trend is expected to continue, and potentially accelerate, in coming years. The reality of this decline and the importance of ensuring it is accurately reflected in the BBM has been pointed out by a number of other respondents to the current process.[4]

Figure 1 below shows the change in the number of fixed voice lines in operation in Australia between 1999 and 2009 (based on ITU data). The figure shows a marked decline in the number of fixed voice lines in operation in Australia.

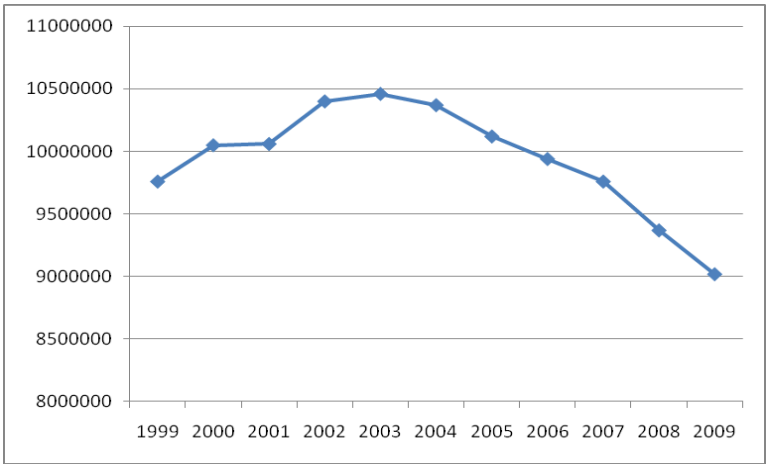
[2] ACCC, *Review of the 1997 telecommunications access pricing principles for fixed line services – Draft Report,* September 2010 ("**Draft Report**"), page 96.
[3] The allocators for ULLS and WLR were set out in Table A7.1 of the Draft Report (see page 95). The allocators for allocators for Other (residual) services can be calculated as 100% less the allocation to ULLS and WLR.
[4] See, for example, *Optus Submission to the Australian Competition and Consumer Commission in response to the Draft Report – Telecommunications Access Pricing Principles for Fixed Line Services*, October 2010, page 10.

The causes of PSTN decline are well recognised by industry commentators and policy makers, and include:

- substitution between fixed and mobile services; and
- increased penetration of IP/broadband-based telephony.

These factors are discussed in greater detail in Schedule 1 to this submission.

Figure 1: Change in the number of fixed voice lines (Australia)[5]



* Source: ITU World Telecommunication/ICT Indicators database

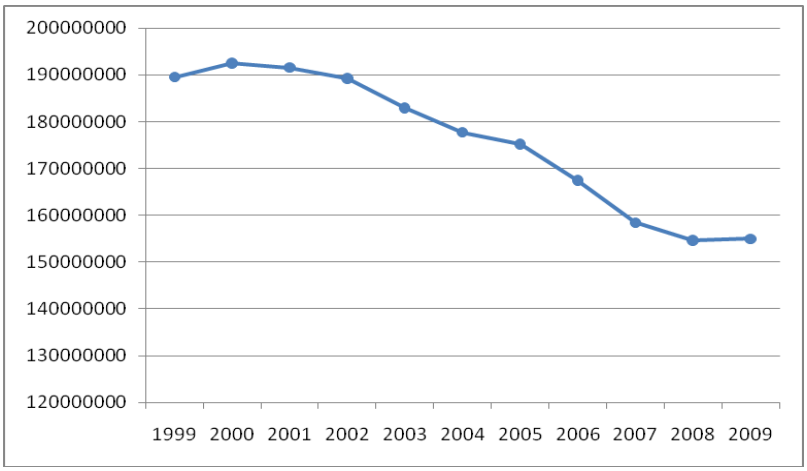
As Figure 1 above illustrates, the total number of fixed voice lines in Australia peaked at approximately 10.46 million in 2003/04. Between 2004 and 2009, this number declined by an average of 2.43% per annum, falling to approximately 9.02 million (or 86% of the 2003/04 peak) by 2009. This is consistent with international trends.

The Australian Communications and Media Authority ("**ACMA**") has recognised that "*while Australia is experiencing a similar rate of decline in fixed-lines, this started later*".[6] ACMA noted that, in France, Germany, Norway and Japan, fixed line numbers peaked in or before 1997. Each of these countries then experienced a number of years of declining fixed line numbers. Similarly, data from the ITU World Telecommunication/ICT Indicators database indicates that the number of fixed lines peaked in the USA in 2000.

Figure 2 below shows the total number of fixed voice lines in operation in the USA between 1999 and 2009. As can be seen, the number of fixed voice lines declined steadily in the USA between 2000 and 2008, before plateauing in 2009.

[5] This figure shows the change in the total number of fixed voice lines operated by all Australian carriers between 1999 and 2009. As a result, it should not be used as a basis for estimating demand for Telstra-operated fixed voice lines. However, it does provide a reliable, independent source of data from which to assess changes in demand for fixed line services.
[6] Australian Communications and Media Authority, *Fixed-mobile Convergence and Fixed-mobile Substitution in Australia,* July 2008, page 16.

Figure 2: Change in the number of fixed voice lines (USA)



* Source: ITU World Telecommunication/ICT Indicators database

Consistent with the experience of the USA and other developed countries, fixed line numbers are expected to continue to decline in Australia over the next four years. In its 2010 Australia Telecoms Sector review, JP Morgan noted that:[7]

> "Experience from OECD incumbents suggests cumulated line loss from peak can reach as much as 25% of total lines. From peak, Telstra lost a cumulated 17% of total lines, as such there would seem to be some further downside to the current level of fixed lines in Australia."

Similarly, Ovum and Business Monitor International ("**BMI**") have also forecast a decline in fixed lines. In its 2010 Fixed Voice Connections Forecast Pack for 2008-15, Ovum predicted that the number of fixed voice lines[8] in Australia will decline by an average of 5.5% per annum between 2010/11 and 2014/15.[9] BMI has also forecast a decline in the number of fixed lines in Australia, although at a more conservative average rate of 1.4% per annum between 2010/11 and 2014/15.[10]

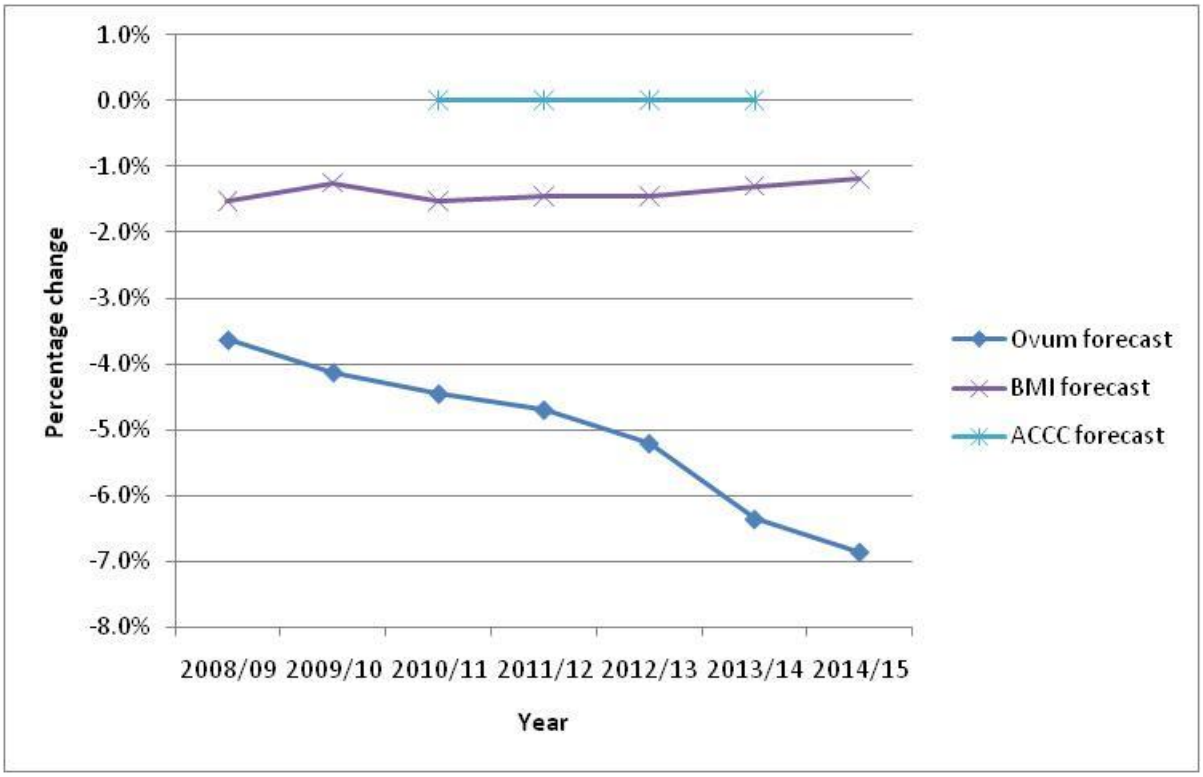
Figure 3 below shows Ovum and BMI's forecasts of the rate of change in the number of fixed voice lines in operation between 2008/09 and 2014/15. It also shows the rate of change in the number of CAN SIOs forecast by the ACCC.

[7] JP Morgan, *Australian Telecom Sector: FY10 Telco review – The end of the Line?* September 2010, page 43.
[8] Ovum defines the term "fixed voice lines" to mean "PSTN lines and ISDN channels that are commercially operational". See Ovum, *Fixed voice connections forecast pack: 2008-15,* April 2010, Definitions.
[9] Ovum, *Fixed voice connections forecast pack: 2008-15,* April 2010, Australia.
[10] Business Monitor International, *Australia Telecommunications Report Q3 2010,* July 2010, page 19. This reflects the expected change in the total number of fixed voice lines across all Australian carriers. BMI has noted that the number of Telstra owned fixed voice lines may decline at a faster rate than the industry average, stating:

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

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

Figure 3: Forecast change in number of fixed lines in operation (2008/09 – 2014/15)[11]



By contrast to the ACCC's forecast of stable demand for CAN services, both Ovum and BMI have forecast that the number of fixed voice lines will decline as more customers switch to mobile services.

As discussed in Telstra's earlier submission, the roll-out of the National Broadband Network ("**NBN**") will also have a significant effect on demand for CAN services. The National Broadband Network Implementation Study ("**NBN Implementation Study**") estimates that, even if Telstra's CAN continues to operate in competition with the NBN, approximately 14-16% of all Australian premises will be connected to the NBN (and migrated from Telstra's CAN) by 2014/15. This figure is likely to be significantly higher if a cooperative outcome between Telstra and NBN Co is achieved, leading to the CAN being progressively decommissioned.[12]

2.2. THERE IS NO TRANSPARENT AGGREGATE FORECAST FOR IEN SERVICES

Telstra is concerned that there is a lack of transparency in relation to the ACCC's forecasts for IEN services.

Telstra has been unable to extract an aggregate forecast for IEN minutes of use, either from the Ovum BBM or from the allocator information recently provided by the ACCC. As a result, Telstra cannot be confident that the allocators used for IEN services have been properly derived, or are based on robust demand forecasts. The allocators used in the Ovum BBM are discussed further below.

Given the significant errors identified with the ACCC's other demand inputs, as discussed in this supplementary submission, Telstra is concerned that aggregate IEN demand may also be inaccurate

[11] As noted above, the Ovum forecast estimates the rate of change in the number of "fixed voice lines". Fixed voice lines are defined as "PSTN lines and ISDN channels that are commercially operational".
[12] The likely impact of the NBN on demand for CAN services is discussed in greater detail in section 5.5.5 (beginning on page 115) of Telstra's earlier submission.

and have a detrimental effect on the appropriateness and reasonableness of pricing outputs from the Ovum BBM.

2.3. LCS FORECASTS DO NOT ALIGN WITH OBSERVED DEMAND TODAY

In support of the demand forecasts used in the Ovum BBM, the ACCC stated in the Draft Report that it had, *"…taken into account the latest actual demand data available for each service."*[13] However, Telstra has compared the ACCC's LCS forecasts with observed demand for the most recent financial year and has identified very large discrepancies. The LCS minutes of usage assumed by the ACCC for 2009/10 are [c-i-c commences] [c-i-c] [c-i-c ends] higher than Telstra's estimated actual demand for the same year.[14]

Figure 4 below shows Telstra's estimated actual LCS minutes of usage for 2009/10. It also shows the ACCC's forecast LCS minutes of usage for the period from 2009/10 to 2013/14.

Figure 4: ACCC forecast LCS minutes of usage (millions) (2009/10 - 2013/14)

[c-i-c commences]

[c-i-c]

[c-i-c ends]

As Figure 4 shows, the ACCC has started its forecast with a minutes of usage figure that is significantly higher than Telstra's estimated actual figure for the same year. The ACCC forecast volumes remain above Telstra's estimated actual figure for 2009/10 for the entire forecast period.

Given that the ACCC's starting point is so out of line with observed demand, Telstra is concerned that the ACCC's forecasts for future years are likely to be similarly inaccurate.

The inappropriateness of the ACCC's forecasts is particularly apparent when they are compared with the historical trends. Figure 5 below compares Telstra's actual LCS minutes of usage between 2002/03 and 2009/10 and the ACCC's forecast LCS minutes of usage between 2009/10 and 2013/14.

Figure 5: Telstra actual and ACCC forecast LCS minutes of usage

[c-i-c commences]

[c-i-c]

[c-i-c ends]

Figure 5 shows the inconsistencies between the ACCC's forecast and Telstra's actual demand. These inconsistencies are not explained in the ACCC's Draft Report. Nor does the Draft Report provide any meaningful detail regarding the 'actual demand' figures the ACCC took into account in preparing its demand forecasts.

[13] Draft Report, page 96.
[14] This is based on 9 months actual data and 3 months forecast data.

2.4. THE IMPACT OF INCORRECT DEMAND FORECASTS ON THE ACCURACY OF THE INDICATIVE PRICES

For the reasons set out above, Telstra is concerned that the ACCC's forecasts are likely to overstate actual demand for CAN and IEN services during the forecast period. As the ACCC's demand forecasts are used to calculate unit prices, this will have a direct impact on the accuracy of the indicative prices and on Telstra's ability to recover its efficient costs.

As discussed in Telstra's earlier submission[15], the ACCC has itself recognised that the Ovum BBM is "highly sensitive"[16] to the accuracy of the demand forecasts used and that:[17]

> "Demand forecasts that overestimate demand may result in the access provider obtaining less than the required revenue. This may create a disincentive for the access provider to invest in efficient infrastructure as the access provider is not assured that it will earn sufficient revenue to receive a reasonable commercial return."

For this reason, Telstra agrees with the ACCC that it would not be in the long term interests of end users ("**LTIE**") for the ACCC to adopt forecasts which are likely to materially overstate actual demand for its CAN and IEN services.

[15] See section 5.5.6 of Telstra's earlier submission.
[16] Draft Report, page 56.
[17] Draft Report, page 46.

3. ALLOCATORS

3.1. DESCRIPTION OF THE ACCC'S ALLOCATION METHODOLOGY

The ACCC has provided Telstra with three Excel spreadsheets that the ACCC has indicated have been used to determine the allocation factors used in the BBM. The Cost.xls spreadsheet (v2.2.1), which forms part of the Analysys model, provides inputs into the Cost Allocation.xls spreadsheet (v0.1), which undertakes the cost allocator calculations. However, the Cost Allocation.xls spreadsheet is not linked to the Ovum BBM.xls spreadsheet. Instead, the ACCC has made adjustments to some of the allocators, which are partially explained in the ACCC's draft report and letter to Telstra dated 7 October 2010. The allocators actually used in the Ovum BBM.xls are hard-coded into that spreadsheet.

3.1.1. CAN DUCT AND PIPE AND COPPER CABLES

For 2009/10, the ACCC allocates the CAN duct and pipe and copper cable to each service based on the ratio of the lines demanded for each service to the total demand for lines. This results in allocators for duct and pipe and copper cables of 8.40% for ULLS and 12.78% for WLR.[18] There is a very small discrepancy, however, in that the Ovum BBM uses an allocator for ULLS of 12.73%. This might be a transcription error.

For later years, the ACCC changes the allocators by multiplying them by the growth in demand for the service. This results in an error as discussed in section 3.2.2.

3.1.2. OTHER CABLES, PAIR GAIN SYSTEMS, OTHER ASSETS

The allocators in the Ovum BBM for Other Cables, Pair Gain Systems and Other Assets do not correspond to the allocators in the Cost Allocation.xls spreadsheet (see Table 3 below, which illustrates the allocators for WLR for 2009/10). There is no explanation for the discrepancy.

Table 3: WLR allocators for 2009/10

	Cost Allocation.xls	Ovum BBM
Other Cables	13.71%	12.24%
Pair Gain Systems	13.48%	12.06%
Other Assets	12.57%	11.26%

3.1.3. SWITCHING EQUIPMENT – LOCAL

The ACCC allocates Switching Equipment – Local to OTA and LCS services in the Ovum BBM. The ACCC set out the allocators for OTA and how it calculated those allocators in Table 1 of its letter to Telstra dated 7 October 2010. It does so by dividing the demand forecasts for OTA and LCS (in terms of end use minutes) in each year from 2009/10 to 2013/14, by the total demand for end use minutes in 2002/03.

The OTA allocators used in the Ovum BBM do not correspond to the allocators calculated using the methodology described in the ACCC's letter to Telstra. The different is set out in Table 4 below.

[18] Draft Report, page 91 and Table A7.1.

Table 4: OTA allocators

	Letter to Telstra	Ovum BBM
2009/2010	10.67%	10.67%
2010/2011	9.60%	9.78%
2011/2012	8.83%	8.96%
2012/2013	8.13%	8.22%
2013/2014	7.48%	7.53%

When the same methodology used for OTA is applied to LCS, the allocators derived are also different to those in the Ovum BBM, as set out in Table 5 below.

Table 5: LCS allocators

	Same methodology as set out in Letter to Telstra	Ovum BBM
2009/2010	7.17%	7.04%
2010/2011	6.45%	6.33%
2011/2012	5.93%	5.83%
2012/2013	5.46%	5.36%
2013/2014	5.02%	4.93%

3.1.4. SWITCHING EQUIPMENT – TRUNK AND OTHER

The ACCC allocates Switching Equipment – Trunk and Other to OTA and LCS services in the Ovum BBM. The ACCC set out the allocators for OTA and how it calculated those allocators in its letter to Telstra dated 7 October 2010. It does so by taking the Switching Equipment Trunk and Other allocators from the Analysys model and scaling them to make the same proportional adjustment as made to Switching Equipment – Local.

Telstra has attempted to replicate the calculation, but derives higher allocators (by approximately 0-4%) to what is input into the Ovum BBM.

3.1.5. TRANSMISSION EQUIPMENT

The ACCC allocates Transmission Equipment to OTA and LCS services in the Ovum BBM. The ACCC set out the allocators for OTA and in part how it calculated those allocators in its letter to Telstra dated 7 October 2010. Telstra has not been able to replicate:

- the calculation of total PSTN call minutes;
- total packet switched data;

- the conversion from Total PSTN call minutes to Convert call mins to Mbps (assuming 64kbps); or

- the difference between the adjusted allocator in the ACCC's letter (13.4%) and the allocator used in the Ovum BBM (8.9%).

The ACCC has not provided any description of how it calculates the allocators for years after 2009/10.

3.1.6. INTER-EXCHANGE CABLES, RADIO BEARER, SATELLITE AND INTERNATIONAL NETWORK CABLES

The ACCC has not provided any description of how it calculates the allocators for Inter-Exchange Cables, Radio Bearer Equipment, Satellite Equipment and International Network Cables. The allocators developed in the Cost Allocation.xls spreadsheet differ from those used in the Ovum BBM, as illustrated in Table 6 below.

Table 6: OTA allocators for 2009/10

	Cost Allocation.xls	Ovum BBM
Inter-Exchange Cables	5.35%	4.38%
Radio Bearer Equipment	5.66%	4.71%
Satellite Equipment	5.65%	4.63%
International Network Cables	3.17%	2.65%

3.2. PROBLEMS WITH THE ACCC'S ALLOCATORS

Telstra has identified the following problems with the ACCC's allocators. These problems do not include instances where Telstra has been unable to replicate the ACCC's calculations (these instances are discussed above).

3.2.1. TRANSCRIPTION ERROR OR MISSING FILES

As discussed in section 3.1 above, the ACCC has provided Telstra with three Excel spreadsheets that it indicated were used to determine the allocation factors. However, Telstra has been unable to reconcile or understand how these spreadsheets are related given the inconsistencies between them.

This is an issue because, as discussed above, there are differences between the allocators calculated using the methodology as set out by the ACCC in its Draft Report, and the allocators used in the Ovum BBM. This implies that there is either an error in the way the ACCC has transcribed the allocators from one spreadsheet to another and/or there are additional workings that adjust the allocators, which the ACCC has not provided for consultation.

3.2.2. ALLOCATORS ADJUSTED INCORRECTLY TO REFLECT CHANGES IN DEMAND THROUGH TIME

The ACCC adjusts the allocators for each service from one year to the next to account for changes in demand for that service. The ACCC states:[19]

[19] Letter from the ACCC to Telstra, dated 7 October 2010, page 6.

> "Over the estimation period, the ACCC has further adjusted the adjusted cost allocation factors to reflect changes in demand over the period. The forecast demands for each service are set out in the Draft Report (at page 96) and the Ovum BBM. Where demand has increased/decreased by X per cent from one year to the next, the cost allocation factor has also been increased/decreased by X per cent."

However, this is not done for all services and assets consistently. For instance the allocators for transmission equipment decrease by much more than demand falls and allocators for pair gain systems grow by much more than demand. This might be due to different treatment of these asset categories.

In any case, it is incorrect to increase/decrease allocators by a growth rate of X% because demand has grown by X%. For example, the allocators for CAN assets in the first year are calculated by dividing the service demand ($Demand_1$) by total demand ($Demand_{All}$):

$$Demand_1 / Demand_{All}$$

Demand for each service and the total demand will change through time by a growth rate. Therefore, the allocator in the second period should be:

$$Demand_1 \times (1 + Growth_1) / Demand_{All} \times (1 + Growth_{All})$$

Thus, the allocator should change from year to year by the ratio:

$$(1 + Growth_1) / (1 + Growth_{All})$$

However, the ACCC's approach is to change the allocator from year to year by:

$$(1 + Growth_1)$$

The ACCC's approach will understate the costs allocated to services when total demand is declining, which tends to be the case for PSTN services. For example, if total demand is forecast to decline by 1%, then the allocators will also be understated by 1%.

3.2.3. LOCAL SWITCHING ALLOCATORS BASED ON 2002/03 DEMAND

The ACCC calculates allocators for local switching by dividing demand for each service in each year of the Ovum BBM (from 2009/10 to 2013/14), by total demand in 2002/03. This allocator is applied to all capital costs, expenses and other costs associated with local switching. For example, the ACCC forecasts 2009/10 OTA demand to be [c-i-c commences] [c-i-c] [c-i-c ends] minutes and 2002/03 total demand to be [c-i-c commences] [c-i-c] [c-i-c ends] minutes. The allocator for OTA in 2009/10 is, therefore, 10.67% [c-i-c commences] ([c-i-c]) [c-i-c ends]. Had the ACCC determined the allocator on the basis of a more recent estimate of total demand, say 91B minutes,[20] then the allocator would be 18.31%. This would imply that [c-i-c commences] [c-i-c] [c-i-c ends] of local switching costs are not being allocated to any services – they are being stranded.

The rationale for doing this appears to be based on the assumptions that local switching demand peaked in 2002/03, that the local switching equipment installed today is provisioned for 2002/03 demand, which results in an over-provisioning, and that Telstra is not entitled to recover the costs associated with any over-provisioning.

There are several problems with the ACCC's approach

First, it assumes that the switching costs incurred to supply demand in 2002/03, are avoidable in 2009/10. However, this is not the case as the full amount of depreciation is still to be recovered on many of those assets. In addition, Telstra must incur operations and maintenance costs to support the assets' continued use.

[20] Telstra cannot replicate the total PSTN traffic estimate by the ACCC for 2002/03, so has used a hypothetical number for 2009/10 to illustrate the materiality of this issue.

Second, it adopts a position that Telstra has no right to recover sunk costs spent prior to 2002/03 in order to meet peak demand at that time. The ACCC argues that *"[Telstra] received compensation for the risk of a fall in demand through its commercial rate of return on assets"*[21]. Telstra disputes that it has previously been compensated for the stranding of its assets.

Telstra considers that it is unreasonable to use an allocation methodology that results in a significant proportion of local switching costs being effectively stranded as they are not allocated to any services. Instead, the ACCC should follow an approach similar to that adopted in Chapter 6A of the National Electricity Rules for the removal of assets from the regulatory asset base. Pursuant to clause 6A.2.3, the Australian Energy Regulator may only determine to remove from the asset base the value of an asset to the extent that, amongst other things, the asset is no longer contributing to the provision of prescribed transmission services (essentially, revenue regulated services) and the service provider has not adequately sought to manage the risk of that asset no longer contributing to the provision of prescribed transmission services. The provisioning of switching equipment to deal with peak traffic in 2002-03 cannot be considered to be inefficient or imprudent. In this regard, the ACCC's approach is unreasonable, including because it does not provide Telstra with a reasonable opportunity to recover at least the efficient costs it incurs in providing the relevant services.

Third, the implication of this approach is that the Revenue Requirement for Switching Equipment – Local costs is not recovered. This is because even though the Revenue Requirement in the Ovum BBM might add up all the revenue required to recover costs, that revenue requirement is not fully allocated to existing demand. The example in the table below illustrates this. The allocator that is required to recover the Revenue Requirement is equal to OTA minutes divided by total minutes in the same year. Adopting the ACCC allocator, which divided 2009/10 OTA minutes by 2002/03 total minutes, would result in a substantial amount of the Revenue Requirement not being allocated to any current services for any year.

	2002/03	**2009/10**	**2010/11**
Total minutes	200	100	80
OTA minutes		10	8
Allocator that fully recovers revenue requirement		10.0%	10.0%
Allocator from ACCC methodology		5.0%	4.0%
% of revenue requirement stranded		50%	60%

More generally, the proportion of the Revenue Requirement in the Ovum BBM that is not allocated to any service, and is therefore stranded, is equal to:

[Total PSTN Minutes (2002/03) - Total PSTN Minutes (year = t)] / Total PSTN Minutes (2002/03)

Fourth, even if the ACCC (inappropriately) adopted a policy of stranding sunk costs that were needed to supply previous demand, it is not clear that the ACCC would be stranding the correct amount. Even if PSTN minutes have declined X%, this does not necessarily mean that X% of assets should be stranded. The ACCC would need to model the cost of the assets that are needed to supply current demand and compare this to the cost of the assets actually purchased by Telstra. This would effectively amount to a replacement cost approach and would be inconsistent with the ACCC's stated

[21] Draft Report, page 92.

intention to use historic costs. However, if the ACCC did not adopt such an approach, its decision regarding the amount of costs to be stranded would be highly arbitrary.

Telstra submits that it would not be in the LTIE for such a significant proportion of Telstra's costs of supplying the fixed line services to be left unrecovered. Effectively stranding these costs would diminish incentives for future investment in infrastructure used to supply fixed line services and would not be in the interests of efficient competition. It would also set a dangerous precedent for other industries.

These errors in the Ovum-BBM allocators, if left uncorrected, will mean that Telstra is forced to bear a disproportionate share of the overall cost of supplying the relevant services. Whilst access seekers may benefit from artificially deflated prices, this will not provide for more efficient competition. On the contrary, there will be a distortion of competition and investment, which is not in the LTIE. Furthermore, not allowing for recovery of these costs would be contrary to Telstra's legitimate business interests.

An additional implication of the allocation approach is that even the cost of new capex added to the RAB during and after 2009/10 is written off as total demand declines. This is because as OTA traffic declines the allocator declines, despite that the total traffic might also be declining. This is also illustrated in the table above. Despite OTA and total minutes declining at the same rate, the amount allocated to OTA drops from 5% to 4% under the ACCC methodology. Even, if the ACCC considers that assets purchased up to 2002/03 should be stranded, which it should not for the reasons above, this does not mean that new capex should also become stranded.

The ACCC's approach sends a clear signal to Telstra that any future capex will not be recovered if PSTN traffic declines. As noted above, this could stymie investment in infrastructure, which would not be in the LTIE.

Similarly, the ACCC's allocation approach also applies to opex and indirect costs (to the extent they are included). Opex is incurred to provide services to current demand. Therefore, it would be incorrect to assume that a substantial proportion of opex 2009/10 and beyond should not be recovered, simply because demand in 2002/03 was higher than it will be in 2009/10 and beyond.

The ACCC's approach sends a clear signal to Telstra that any future opex will not be recovered.

3.2.4. THERE IS NO TEST TO ENSURE ALL ALLOCATIONS ADD TO 100%

It is common practice in the determination of allocators for a particular set of services, to ensure that the allocations to all services add to 100%. This is an assurance that the allocation rules result in cost recovery, and not over or under recovery.

The ACCC has not provided such a test. As detailed above, Telstra is concerned that some of the allocators are defined in a way that results in the total amount of cost allocated not equalling the total amount of cost that needs to be recovered.

In the interests of transparency and robustness, Telstra encourages the ACCC to undertake and release a test to ensure that the allocations to all services that use the relevant assets included in the Ovum BBM add to 100% in each year.

4. SCHEDULES

SCHEDULE NUMBER	TITLE
1.	**Explaining the decline in CAN services**
2.	**Confidential material redacted from supplementary response**

Schedule 1: Explaining the decline in CAN services

As noted above, analysts and regulators generally agree that a key factor contributing to the decline in fixed line numbers is the migration of customers from fixed to mobile services. For example, in its 2010 Australian Telecommunications Report, BMI noted that:

> "Generally speaking, demand for traditional fixed-line telephony has been in decline. This has been due to the popularity, both in terms of convenience and price, of mobile services."[22]

The advent of new technologies, such as VoIP and wireless internet which allow individuals to make calls and access the internet without a fixed telephone line have also contributed to a decline in fixed line demand. In this regard, ACMA's 2008/09 Communications Report indicated that:

> "The number of fixed-line standard telephone services in Australia declined during 2008-09...The drop in fixed-line services is accounted for by continuing substitution of these services with other technologies such as 3G and VoIP. It is estimated that approximately 10 per cent of people aged 14 years and over in Australia and four per cent of small and medium enterprises (SMEs) did not have a fixed telephone service during the 2008-09 reporting period."[23]

The Australian Bureau of Statistics' 2010 Review of Internet Activity concluded that mobile wireless internet (excluding mobile handset connections) was the fastest growing form of internet access, increasing by 21.7% between December 2009 and June 2010.[24] BMI has noted that the increase in wireless internet use has contributed to a decline in demand for fixed line services stating:

> "...demand for traditional fixed line telephony has been in decline. This has...been due to a fall in demand for fixed broadband services, which has, in turn, been fuelled by the rapid rise in demand for mobile broadband alternatives. The growth of mobile broadband services has eroded the market for bundled packages, which include a fixed voice and fixed broadband connection within the same package."[25]

This trend is expected to continue in the future, with a growing number of residential and business customers expected to give up their fixed telephone line and rely solely on wireless services. In this regard, the Australian Communications Consumer Action Network has predicted that, between 2009 and 2014 there will be:

> "...a substitution of fixed lines by mobiles, Internet Protocol (IP)/digital networks and interactive applications."[26]

[22] Business Monitor International, *Australia Telecommunications Report Q3 2010,* July 2010, page 19.
[23] Australian Communications and Media Authority, Communications Report 2008/09, November 2009, page 15.
[24] Australian Bureau of Statistics, *Internet Activity – Australia,* June 2010.
[25] Business Monitor International, *Australia Telecommunications Report Q3 2010,* July 2010, page 19.
[26] Australian Communications Consumer Action Network, *Future Consumer: Emerging Consumer Issues in Telecommunications and Convergent Communications and Media,* 2009, page 5.