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Dear Mr Wright

We refer to your letter of 18 December 2008 responding to Telstra's letter of 2 December 2008 which raised 28 separate questions seeking clarification of the ACCC's November 2008 Draft Decision on Telstra's Band 2 ULLS Undertaking. I note that the ACCC has answered just 5 of the 28 questions raised by Telstra.

Telstra has now had an opportunity to consider the responses provided by the ACCC and is concerned that:

- the assessment of Telstra's Band 2 ULLS Undertaking is not being carried out in an open and transparent manner. Telstra is not being afforded the opportunity to understand the ACCC's concerns and therefore to address those concerns with its supporting evidence; and
- this lack of transparency has very serious implications for the accuracy of the ACCC's decision making on Telstra's Undertaking. The errors that we identify below in the responses which have been provided by the ACCC serve to exacerbate those concerns.

Inaccuracies revealed by the ACCC's responses

The responses which the ACCC has provided raise serious questions about the accuracy of the analysis underlying the ACCC's Draft Decision. A full examination of the responses is set out in the Appendix below.

In short, it is apparent that:

- the ACCC's calculation of Telstra's historic costs, which it compares to Telstra's Undertaking price of \$30, excludes any allocation of indirect costs and ULLS specific costs which should reasonably be included in a cost-based price. This makes the comparison one that is not like-for-like;
- it appears that the ACCC has changed breakout and reinstatement vendor prices in the TEA model to the values applicable to trenching and reinstatement in turf. In so doing, the ACCC has either assumed that roads,

footpaths and driveways are comprised of turf, or assumed that all telecommunications networks are constructed in a “scorched earth” environment, where all construction is complete before roads, driveways and footpaths are in place. Both assumptions are wrong;

- the international benchmarking study in the Draft Decision is purportedly based on purchasing power parity (PPP) rates to convert foreign currency to Australian currency. Contrary to the assertion in the Draft Decision, the ACCC’s response to Telstra’s letter of 2 December 2008 shows that the ACCC’s analysis does not use PPP but, instead, uses a ‘composite’ rate;
- the ACCC’s response to Telstra’s questions indicates that the ACCC has converted foreign currencies into USD using a composite rate at one point in time and then from USD into AUD using a nominal exchange rate at another point in time. It is inappropriate to mix conversion methods and times in an international benchmarking exercise;
- the ACCC’s method of calculating the proportion of trench sharing in new estates over 17 years does not account for the fact that trenching and reinstatement is on occasion required after the developer has completed the new estate. It is manifestly unreasonable for the ACCC to depart from a TSLRIC approach in this manner and not add back in costs imbued in its alternative hypothesis;

Telstra requests that the ACCC respond to the queries set out in the below Appendix.

Telstra would expect that issues such as these are typically discovered and resolved by the ACCC through a process of consultation with Telstra and industry. However, in this case, the ACCC is choosing to consult on only 5 of the 28 questions raised by Telstra. That limited consultation raises serious concerns about what issues might exist relating to topics the subject of the 23 other questions that the ACCC chose not to consult on and, therefore, about the accuracy of the ACCC’s Final Decision when it is made.

Responses not provided

Telstra’s objective in asking the questions contained in its letter of 2 December 2008 was not to place an unnecessary burden on the ACCC or to delay the consideration of Telstra’s Band 2 ULLS Undertaking in any way.

On the contrary, Telstra wishes to ensure that it can, as best as possible, satisfy any concerns identified by the ACCC in its Draft Decision in order to satisfy the ACCC that the Undertaking terms are reasonable. We are concerned that we are being denied a reasonable opportunity to do this.

Telstra notes the ACCC’s express acknowledgement (in its *Guide to the resolution of telecommunications access disputes*) that the requirements of procedural fairness (or natural justice) apply in relation to its decision to accept or reject an access undertaking. Prior to accepting an undertaking the ACCC must be satisfied that the terms and conditions specified in the undertaking, most importantly here, the price, are reasonable. The ACCC has taken the view that, if a number of the major inputs and/or assumptions used in the TEA model are not reasonable, it cannot be satisfied that the price term is reasonable. Even though Telstra has, prior to the publication of the Draft Decision, submitted extensive material in relation to the inputs /assumptions /workings of the TEA model, in the Draft Decision, the ACCC has

expressed its view that it is still not satisfied Telstra's proposed undertaking is reasonable.

As you can appreciate, however, due to the number of inputs and assumptions and the volume of material submitted, a full understanding of the views expressed by the ACCC in the Draft Decision is extremely important to notify Telstra of what else it needs to submit in order for the ACCC to be satisfied that the price term is reasonable. If the source of the ACCC's discomfort were clear, Telstra could either provide further material in order for the ACCC to reach the required level of satisfaction or, given that the cost estimates produced by the TEA model are substantially higher than the price proposed in the Undertaking, if the change considered by the ACCC to be reasonable has an immaterial or small impact on the resulting cost, demonstrate that fact to the ACCC, again showing that the ACCC can be satisfied that the price term is reasonable.

Telstra asked the questions in its letter of 2 December 2008 in an attempt to provide genuinely informed and meaningful submissions and material in relation to the preliminary views set out in the ACCC's Draft Decision so as to satisfy the ACCC that the Undertaking price is reasonable. The fact is, Telstra does not understand some of the ACCC's preliminary views as expressed in the Draft Decision. This makes it impossible for Telstra to provide fully informed and meaningful submissions on those aspects of the Draft Decision and similarly impossible to provide material to the ACCC so that it can be satisfied that the Undertaking price is reasonable.

By way of one example, given the ACCC's statement in the Draft Decision that "*design and implementation issues mean the extent of the efficiencies [reflected by the TEA Model] is not as extensive as claimed by Telstra*", Telstra asked the ACCC to provide clarification/explanation regarding which optimisation and efficiencies it would like included in the TEA model design in order to satisfy the ACCC that the TEA model reflects efficiency savings. The ACCC has not responded to this request.

In relation to this example, the absence of clarification/detail makes it impossible for Telstra to know which efficiencies and optimisations the ACCC considers Telstra has not addressed. Given that there are literally thousands of assumptions and inputs into the TEA model, the general statement made by the ACCC makes it impossible for Telstra to provide the relevant material within the timeframe so as to satisfy the ACCC on this aspect of the TEA model and so that it can be satisfied that the price term in the Undertaking is reasonable. Continuing the example, if the ACCC articulated what further efficiencies it considers appropriate, Telstra would be able to verify whether they are already considered in the TEA model or even make appropriate adjustments to the TEA model so that they are reflected. This would, in all probability, lead the ACCC to be satisfied with the reasonableness of this aspect of the TEA model.

While Telstra has responded, to the extent that it is currently able, in its submissions made on 23 December 2008, the ACCC's Draft Decision does not adequately disclose or explain a number of the ACCC's apparent concerns in a way which allows Telstra a fair opportunity to address them. As such, Telstra has requested further information and clarification from the ACCC on some aspects of the Draft Decision to ensure the material it provides "fills any holes" which the ACCC has identified with the material which Telstra has provided to date.

Telstra is entitled to an opportunity to make such submissions prior to the Final Decision

As mentioned above, the ACCC has answered only 5 of the questions set out in Telstra's letter of 2 December 2008. In this regard, your letter states:

“The ACCC considers that most of the issues raised in your letter will, where necessary, be addressed in the final decision. With regard to these issues, the ACCC considers that it has been transparent in setting out the reasoning for its views and the information it has relied upon.”

As a reason for not answering all the questions, you go on to explain:

“It should also be noted that the draft decision is not a final articulation of the ACCC’s decision. It is a draft document reflecting the ACCC’s preliminary views on a particular issue, and requires further comments from interested parties. These comments, such as the ones raised in your letter, can then be addressed in the final decision.”

If the ACCC waits until the final decision to provide answers to Telstra’s questions, then Telstra has no opportunity to place material before the ACCC to satisfy it in relation to the reasonableness of the TEA model and hence the price term of the Undertaking. Plainly, the purpose of publishing the Draft Decision is to elicit submissions from interested parties on the ACCC’s preliminary views regarding particular issues prior to the ACCC making its final decision on the Undertaking. It is also to ensure that Telstra has a fair and reasonable opportunity to discharge its burden of satisfying the ACCC that the Undertaking is reasonable. It is difficult to see how this can be achieved if the ACCC intends to address Telstra’s requests for clarifications/answer questions only once it has reached the point of finalising its views. To continue the above example, Telstra will have no opportunity to address or respond to any further clarification provided regarding the optimisations/efficiencies the ACCC considers are absent from the TEA Model, once the ACCC’s final decision on the Undertaking is made.

If the ACCC elects not to provide further clarification by answering Telstra’s questions at this time and before reaching its final decision on the Undertaking, pursuant to the concepts of procedural fairness and natural justice, Telstra and the other interested parties should have an opportunity to submit additional evidence to the ACCC to respond to any clarifications or issues raised for the first time later in the process.

Telstra therefore repeats its request that the ACCC answer each of the questions raised in Telstra’s letter of 2 December 2008.

Weighted Average Cost of Capital

In the ACCC’s Draft Decision, the ACCC relies on Ovum’s estimate of Telstra’s WACC (8.58%) to conclude that Telstra’s WACC of 12.28% is unreasonable. Telstra notes that the ACCC has not used its own WACC in the Draft Decision, despite the fact that in June 2008 the ACCC released its Pricing Principles for 08/09 ULLS prices in which the ACCC determined Telstra’s ULLS post-tax WACC to be 10.15%, considerably higher than Ovum’s WACC.¹

At page 84 of the ACCC’s *Guide to the resolution of telecommunications access disputes March 2004* the ACCC says:

“The purpose of determining and publishing pricing principles for specific services is to inform industry, government and other interested parties about the principles that are likely to guide the ACCC when considering an access dispute or assessing an undertaking in relation to the relevant declared service.”

¹ *Unconditioned Local Loop Service, Pricing Principles and Indicative Prices*, June 2008, page 18. 9757186_1

Telstra understands that the ACCC has specific “in-house” expertise in the subject of valuing WACC. We understand that that expertise is held in a central function within the ACCC in order to ensure consistency across regulated industries. It is not apparent however whether the ACCC has brought that expertise to bear in formulating its Draft Decision on the reasonableness of Telstra’s WACC, as distinct from merely adopting the views of Ovum on WACC. Similarly, it is not apparent what consideration was given by the ACCC to its own 08/09 ULLS Pricing Principles on that topic.

If the ACCC’s own expertise and judgement was brought to bear on Telstra’s WACC, but was not referred to in the Draft Decision, Telstra requests that the ACCC explain those views in sufficient detail for Telstra to understand and respond, including the inconsistency with its own 08/09 ULLS Pricing Principles. If however the ACCC merely intends to adopt the views of Ovum on WACC then Telstra would appreciate confirmation of this, and an explanation as to why the ACCC is not having regard to its own 08/09 ULLS Pricing Principles.

Conclusion

For the reasons set out above, Telstra requests that the ACCC:

- respond to its full list of questions provided on 2 December 2008;
- respond to the concerns Telstra has identified in the below Appendix in relation to the five responses provided by the ACCC on 18 December 2008; and
- provide an explanation of why the ACCC is relying on Ovum's post-tax WACC of 8.58% as opposed to its own post-tax WACC of 10.15%.

Yours sincerely,



Tony Warren
Executive Director Regulatory Affairs
Public Policy and Communications

APPENDIX

1. Direct Costs

Could the ACCC explain/provide the workings and analysis underlying the information in Table 6.1 of the draft decision?

Telstra notes the following in relation to the ACCC's analysis:

First, the ACCC has calculated the return on capital associated with only those CAN assets reported in the RAF. For example, the RAF excludes CAN assets that were purchased prior to the dates as set out in the table below. Thus, the RAF does not reflect the full capital costs of Telstra's CAN.

RAF Category	Asset Category	Asset Category Description	Latest year for which no financial data exists in the RAF
CAN Duct and Pipes	XC	DUCTS & PIPES - MAIN CABLES	1967
	XN	DUCTS & PIPES - DISTRIBUTION CABLES	1980
CAN Copper Cables	XU	MAIN CABLES	1978
	XD	DISTRIBUTION CABLES	1980

Second, the ACCC has used Ovum's pre-tax WACC of 9.22%, which is substantially below even the ACCC's pre-tax WACC of 11.35% for the 2008/09 year.²

Third, the ACCC's analysis counts only direct network costs and excludes any contribution to indirect costs such as accommodation, general administration and network support. Since these later costs are reasonably included in a cost-based price, a comparison between the ACCC's incomplete calculation of historic costs and the \$30 price in Telstra's Undertaking would not be like-for-like.

Fourth, there are no ULLS specific costs included in the ACCC's calculation. The ACCC estimated in 2008 that ULLS specific costs were \$2.50. These should be added to the ACCC's calculation of historic costs to compare to the \$30 monthly charge in Telstra's Undertaking.³

Fifth, the ACCC's analysis excludes radio bearer equipment assets in the cost, as it appears the ACCC's intention is to calculate the unit cost of non-radio CAN SIOs. However, the ACCC appears to have divided the total non-radio cost by all SIOs, including radio SIOs when calculating the unit cost. If so, the ACCC's calculation will understate the unit cost of non-radio CAN SIOs.

Sixth, for the calculation of the historic O&M and depreciation costs the ACCC's analysis is linked to the current cost accounts. While this has no impact on the analysis as put forward by the ACCC, it is likely to if the ACCC had properly included

² ACCC (2008), *Unconditioned Local Loop Service Pricing Principles and Indicative Prices*, June 2008, page 18

³ ACCC (2008), *Unconditioned Local Loop Service Pricing Principles and Indicative Prices*, June 2008
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indirect costs. For consistency, the ACCC's analysis should link to the historic cost accounts.

2. Variable Inputs

Could the ACCC provide the excel spreadsheets or other computer model runs which were performed by the ACCC in running its scenarios with "other parameter values", which led the ACCC to conclude that there is "significant doubt as to whether the Proposed Monthly Charge of \$30 is reasonable"?

In any case, could the ACCC provide a complete set of values for inputs into the TEA model that it used in arriving at its draft decision to reject the Undertaking?

It appears that the ACCC has changed breakout and reinstatement vendor prices to the values applicable to trenching and reinstatement in turf. In doing so, the ACCC has either assumed that roads, footpaths and driveways are comprised of turf, or assumed that all telecommunications networks are constructed in a "scorched earth" environment, where all construction is complete before roads, driveways and footpaths are in place. Both assumptions are wrong. Importantly, these vendor prices apply to areas outside new estates, so this cannot be explained by a premise that developers in new estates incur these costs.

3. International Benchmarking

Telstra notes that there are several substantial errors in the ACCC's international benchmarking analysis.

First, typically when international benchmarking is used to determine prices, much care must be taken to ensure that the selection of countries to be benchmarked is comparable to the subject country, in this case Australia. However, the ACCC appears to have taken only and all those countries included in Ovum's commercial benchmarking report. It appears that no consideration has been given to whether the countries included by Ovum are appropriate comparators for Australia nor has there been any consideration as to whether additional countries that Ovum has not included should be included.

For instance, the Netherlands is characterised by low lying, flat land comprised mostly of malleable soil, while Sweden has large areas of mountainous terrain. These characteristics bear on the costs of deploying a network and mean that costs in those countries would not compare well to Australia, which does not have many mountainous areas and has relatively rocky terrain. The ACCC does not seem to consider these factors, as it has simply adopted all countries reported by Ovum.

Additionally, there are many countries that are more comparable to Australia but which do not feature in the Ovum study – the United States in particular. Since the ACCC simply adopts only those countries in the Ovum study, its benchmarking analysis is based on a restricted and perhaps biased sample.

Second, it appears that in converting the Euro based price to US dollars, the ACCC has truncated the Euro/USD exchange rate to two decimal places. This does not have a substantial effect on the results, but for accuracy the ACCC should not round the exchange rates, as this will result in rounding error.

Third, the ACCC has started with Ovum's prices in Euro denomination and converted them to USD using Ovum's exchange rates at an indeterminable point in time. The ACCC then converts the USD values to AUD using the ACCC's rate at another point in

time (31/12/2007). There will be an error in the ACCC's analysis if the date for the Ovum exchange rate is different to the date for the ACCC exchange rate. This is particularly important given recent drastic changes world exchange rates over the last 12 months, which could cause substantial error in the ACCC's analysis. For instance, the average exchange rate since when Telstra's undertaking began (1 January 2008) to 6 February 2009 is 0.8365 and the rate as at 6 February is 0.64750. Using the current rates would increase the foreign ULLS prices converted into AUD.

Fourth, despite representing the benchmarked prices as being converted with PPP rates in the Draft Decision, the ACCC has not used PPP exchange rates but rather a composite rate created by Ovum. The ACCC has provided some further information about Ovum's composite exchange rate in response to Telstra's questions, set out in the ACCC's letter dated 18 December 2008. The ACCC states that "*The Ovum benchmarking report quotes a USDEURO composite exchange rate of 0.77 calculated by: exchange rate composite = 0.6 (PPP) + 0.4 (exch. rate)*". There is no explanation or science behind the choice of the weights. The ACCC seems to acknowledge that it too has concerns with the approach it chose by also saying "*The ACCC adopted the use of the composite rate but may revise this methodology in the Final Decision on Telstra's ULLS Undertaking*". Telstra encourages the ACCC to consult on a replacement approach before adopting another approach in the final decision.

Fifth, again in the calculation of PPP rates, the ACCC states that it uses the composite rates (truncated to 2 decimal places) to convert from Euro to USD and the nominal exchange rate to convert from USD to convert to AUD. Without knowing what Ovum's composite rate is meant to represent, it appears inappropriate to mix composite and nominal exchange rate conversions. If the ACCC intended to present the composite rates in the Draft Decision (it stated in the Draft Decision that the rates were PPP when they were not), it should have used the composite rate to convert USD to AUD, not the nominal exchange rate. This appears to have been done in the example for Austria provided in the ACCC's letter (the ACCC used a composite rate of 0.797), however, the approach in the example is not the approach carried out in the Draft Decision. For example, the PPP price for Austria in the Draft Decision is \$13.81 but in the example provided later by the ACCC it is \$15.22.

Sixth, even adopting the ACCC's method set out in the ACCC's letter, Telstra is unable to replicate the results in the Draft Decision. Using Denmark as an example:

- Ovum's reported price for Denmark is 9.72 Euros.
- This is converted to USD \$12.62 (using a composite rate of 0.77)
- This is converted to AUD \$14.38 (using a nominal rate of 0.8776)

However, the price for Denmark in the Draft Decision is AUD \$9.97.

4. Trench Sharing

What is the precise basis for the ACCC's estimate that "a trench sharing value of between 13-17 per cent approximates cumulative trench sharing potential in new estates" and please clarify/explain how the calculation of the percentages was performed?

A reasonable price for ULLS is based on the costs of a new entrant. Such a price will ensure that the correct incentives exist for new investment in the CAN and will promote new facilities based competition over the long run. The new estates trench sharing variable should, therefore, be based on the proportion of trenches that a new entrant could share with developers of new estates. The new entrant could only take advantage of open trenches in new estates that are under development during the course of the new entrant's network build.

The ACCC calculates that between 13% and 17% of trenches are in new estates, which appears to be based on an assumption that a new entrant would have shared trenches from 1992. The ACCC asserts “*this year was selected as the practice of sharing trenches by utility providers was well established for new housing estates*”. The historical approach to trench sharing is inconsistent with principle of basing prices on forward-looking costs. It will result in prices that are below the costs of a new entrant replicating Telstra’s CAN and, therefore, will discourage new investment and in the long term facilities based competition.

It also appears from the calculation set out in the ACCC’s letter that it is assumed that over the 17 years of new estate development, no additional trenching and reinstatement is required after new estate developments have been completed. This would be incorrect as Telstra is often required to add capacity as those estates expand and change.