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16 JUL 2014

NBN Co Payments to Telstra & ACCC Fixed Line Access Determinations

Dear ~~Mr Sims~~ Rod

This letter refers to the Australian Competition and Consumer Commission's (ACCC) continuing public consultations and proposed release of a discussion paper in relation to final access determinations for fixed line services under Part XIC of the *Competition and Consumer Act 2010*.

We note preliminary submissions to the ACCC from Optus, from NERA on behalf of Optus, and from Frontier Economics on behalf of TPG and iiNet. These submissions argue that the benefit to Telstra of payments it receives from NBN Co under the June 2011 Definitive Agreements (DAs) should be taken into account in setting access prices for fixed line services. [1]

It is our view that in considering these submissions, the ACCC should recognise the structural reforms underway in the supply of fixed line telecommunications, including:

- Rollout of the National Broadband Network (NBN) facilitated by the DAs.
- Progressive structural separation of Telstra via customer migration to the NBN.
- The approval in December 2013 of a Special Access Undertaking (SAU) from NBN Co providing greater long-term certainty for the company and access seekers.

These initiatives will transform the telecommunications sector. Retail competition will be enhanced by upgrading the infrastructure used by Retail Service Providers (RSPs) and addressing competition issues arising from vertical integration. The ACCC's February 2012 decision on Telstra's SSU and draft Migration Plan and December 2013 approval of NBN Co's SAU are premised on these structural reforms being in the long term interests of end-users.

[1] The payments discussed in the submissions are the Per Subscriber Address Amount (PSAA) and lease payments under the Infrastructure Services Agreement (ISA). Both accrue as NBN Co progressively overbuilds Telstra's local access network and customers using this network are moved to the NBN over an 18 month period. About 65 per cent of ISA payments, by value, arise as NBN Co leases and uses Telstra exchange space, underground ducts and other passive infrastructure to extend the NBN network to all premises in an area. The PSAA is paid as premises with an existing service over a Telstra line are disconnected from Telstra's network, which is then decommissioned. The residual 35 per cent of ISA payments, by value, arise from dark fibre and exchange space leased for NBN's transit network.

As the reforms proceed, we ask that the ACCC be mindful of the valuable role that stability, regulatory consistency and adherence by all parties to jointly agreed commitments can play in assisting their successful conclusion.

In this context there are a number of reasons why the NBN Co's payments to Telstra should not be a consideration in determining access prices for fixed line services. They go to matters of both principle and practice. Three of the most powerful are outlined below.

Parties have committed to industry reform on an agreed basis

The payments that NBN Co (and, separately, the Government) committed to make over time to Telstra were commercially negotiated by the parties and are part of the agreed terms for Telstra's participation in the industry reforms enabled by the DAs.

In 2009 the then-Government decided to pursue structural reform of the telecommunications sector by commencing a fibre-to-the-premises NBN, and legislating for the mandatory functional or voluntary structural separation of Telstra. This led to complex and protracted negotiations in which Telstra sought to reduce the commercial impact of these policies and Government and NBN Co sought Telstra's participation in the NBN and other reforms.

The resulting DAs agreed in June 2011 amount in commercial substance to a disposal by Telstra of its wireline customer access networks and wholesale customers, and purchase by NBN Co of the wholesale value of these customers (if not the transfer or use of any underlying network assets, in the original form of the deal). For the convenience of both parties this transaction was effected progressively, through the gradual rollout of the NBN network, which triggered disconnection payments and initiated long-term lease income streams.

In return for these payments Telstra agreed to progressively decommission its fixed customer access networks and exit the local wireline access market, migrate customers from its wireline networks to the NBN, commit to the exclusive use of the NBN for its fixed line service offerings for 20 years, and provide long-term leases over passive infrastructure to NBN Co. [2]

The terms agreed by Telstra, NBN Co and Government were approved by Telstra's 1.4 million shareholders in October 2011.

It will undermine the integrity of this deal if Telstra shareholders are deprived of the benefit of arrangements they did not initiate but negotiated in good faith. This may weaken Telstra's commitment to current reforms. In a worst-case scenario it may even prevent proposed amendments to the Das which provide NBN Co with access to existing infrastructure that enables the overall cost of the NBN to be reduced by an estimated $30 billion.

It is extremely difficult to see how any of these outcomes would be in the long term interests of end-users.

We note the carriers associated with the submissions lodged with the ACCC, along with many others, argued strongly for both a fibre-to-the-premises NBN and the structural separation of Telstra, seeing these as beneficial to their long term commercial interests (and, presumably, the long term interests of end-users).

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[2] Note Telstra argues the 2009 policies still resulted in material commercial detriment: "The Government's policy initiatives will result in a net loss of value to Telstra overall, irrespective of whether Telstra participates in the rollout of the NBN." Catherine Livingstone, Chairman, Telstra – 'Letter to Shareholders' in 'Explanatory Memorandum to Telstra Shareholders, NBN Proposed Transaction' – 1 Sep 2011.

All three carriers clearly understood the commercial value of the commitments sought from Telstra, and the centrality of those commitments to the reform process. It is disappointing to see them pursuing short term financial advantage which, if obtained, may endanger lasting structural reforms. Again, the consistency of this with the long term interests of end-users should be carefully considered.

As a matter of principle it is unclear why progressive sale of Telstra's customer access network should reduce the cost base of the part of the network which at any given time remains unsold.

Price stability is vital during this period of transition

The ACCC has repeatedly and appropriately emphasised the importance of price stability for access seekers and end-users during the transition from services on Telstra's networks to services on the NBN. In its final decision on the NBN Co SAU, the ACCC concluded: "To the extent that a functionally equivalent service is available, the ACCC considers that end users should not be made worse off by virtue of their migration to the NBN. In particular, to ensure that initial maximum regulated prices will promote the long-term interests of end users, it is important that end users do not experience a 'price shock' due to migration…" [3]

If payments under the DAs are subject to a regulatory treatment which temporarily reduces access prices for carriers to use Telstra's network, this may constitute such a price shock.

Reductions in access charges passed to consumers as lower retail prices will open a gap between entry-level broadband prices on the Telstra network and equivalent offerings on the NBN. While most consumers would prefer lower broadband prices while they wait for the NBN, price differentials that favour legacy networks will delay migration, and mislead consumers about the prices they should expect in the future.

Even if reduced access prices are not passed to consumers but retained by RSPs as higher operating margins, the issue of a price shock that distorts the migration to the NBN remains, as RSPs will have an incentive to attempt to delay the transition.

In both cases NBN Co revenue and customer growth will be deferred, as will attainment of the customer scale needed for NBN Co to cover its fixed costs, operate efficiently and be positioned to reduce real prices over time. If NBN Co responds by lowering wholesale prices to align with those on the Telstra network, this will reduce its resources for proceeding with the rollout.

While enforced migration to the NBN ultimately addresses most of these problems, consumers will resist paying higher prices, and pressure may emerge to delay or abandon disconnection of legacy networks – threatening the viability of NBN Co and objective of structural separation.

This is a far from hypothetical problem. Recent experience in New Zealand illustrates the importance of considering price outcomes across the market as a whole. The long-term interests of end-users test allows the ACCC to consider the implications of its decisions for users of different platforms and in light of other regulatory decisions. It encourages coordinated decisions to maximise consistency and minimise perverse outcomes.

It is complex and risky to assess which, if any, DA payments affect access prices

These concerns of principle are reinforced by the practical difficulty of quantifying and implementing access price adjustments of the type proposed by Optus, TPG and iiNet.

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[3] ACCC – Final Decision: NBN Co Special Access Undertaking – Dec 2013, p.85.

In establishing prices derived from a building block model, the focus is on costs rather than revenues. That is, the first best approach is to establish the cost base for the relevant assets and then consider demand for those services to establish prices. Revenues typically play little role in this process. At best they serve to identify which assets should potentially be included or excluded from the asset base.

Differences in the types of payments Telstra receives from NBN makes it necessary to determine which (if any) are theoretically relevant to setting access prices. The DAs encompass one-off payments received by Telstra after customers are migrated to the NBN and premises are disconnected from its networks; recurrent payments for long-term leases over passive infrastructure provided to NBN Co; and proceeds from outright sale of lead-in conduits. None closely resembles Telstra's regulated revenues from fixed line services.

The nature of some payments may change under possible amendments to the DAs (if, for example, network assets are transferred rather than decommissioned), causing further categorization complexity, while the timing – and therefore present value – of a majority of DA payments by value are contingent upon the progress of the NBN rollout.

Correctly estimating the appropriate adjustments to access prices would require the ACCC to:

- Establish the purpose, structure and timing of all NBN-related payments and quantify which (if any) should be subject to differential regulatory treatment.
- Identify which (if any) network assets are simultaneously used by NBN Co and in the provision of fixed line services (and the timeframe for which this is true).
- Make appropriate adjustments to the regulated asset base.
- Determine changes to the volume of services in operation that require ongoing use of the fixed line network, which would then permit determination of unitised wholesale costs of service.

A consistent treatment of NBN-related payments also depends on reliably forecasting demand at multiple points in time, given the dynamic nature of the platforms used to supply these services. The challenge of achieving the required forecasting precision will be exacerbated by the transition to a multi-technology mix NBN.

With so many variables and unknowns these are problematic calculations.

The intractable complexity of identifying and valuing the payments (if any) which should be taken into consideration in determining access prices creates a large and irreducible risk of regulatory error.

Complex adjustments to modeling at various intervals could generate fluctuating results across a wide range of outcomes, and all results are likely to be sensitive to assumptions that are difficult to validate.

Way forward

These are not the only arguments against the thrust of the submissions made by Optus, TPG and iiNet. There are several further economic arguments more appropriately left to a formal submission the Government currently intends to bring forward on these matters following the ACCC's proposed discussion paper.

Under the DAs the payments Telstra negotiated in return for its progressive exit from the fixed local access market will be received at roughly the time it transfers customers to the NBN, decommissions or deactivates the relevant parts of its legacy networks, and ceases using the passive infrastructure it will usually have just leased to NBN Co.[4]

It is open to the ACCC to recognise that changes in the regulatory revenue requirement will be broadly proportional to changes in the volume of services.

Therefore, even if complex calculations for adjusting access prices were found to have a sound legal and commercial basis and to produce accurate adjustments, the net change in outcomes may well be marginal.

The ACCC may choose to consider whether the long term interests of end-users would be best served by adopting this approach and including a fixed principle to this effect in the fixed line services access determinations.

We urge the ACCC to expedite its consideration of these issues and if it is so inclined, propose a fixed principle of this kind as soon as practicable.

This would have the benefit of providing regulatory certainty during a period of industry transition, be consistent with the ACCC's commitment to price stability, and help smooth migration to the NBN by consumers.

Alternatively, if the ACCC sees merit in the submissions it has received from or on behalf of Optus, TPG and iiNet, it should provide guidance in its forthcoming discussion paper as to the constraints and methodology it intends to apply in adjusting access prices to account for DA payments, and outline its strategy for addressing the elevated risk of regulatory error such a step entails.

Kind regards

Malcolm Turnbull
Minister for Communications

Mathias Cormann
Minister for Finance

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[4] Timing of these payments is broadly aligned as they fall in an 18 month interval where Telstra may be paid for services by parties which have not yet migrated, prior to forced disconnection of non-NBN services other than special services.