

**13 February 2012**

Mr Michael Cosgrave  
Group General Manager  
Communications Group  
Australian Competition and Consumer Commission  
GPO Box 520  
Melbourne VIC 3001

By email: [michael.cosgrave@accg.gov.au](mailto:michael.cosgrave@accg.gov.au)

Dear Michael,

### **NBN Co's Special Access Undertaking (SAU) – Initial Industry Submissions**

We refer to the ACCC's Consultation Paper on the NBN Co Special Access Undertaking (the **ACCC Consultation Paper**) published on 20 December 2011, and the submissions to the ACCC Consultation Paper which have been published on the ACCC's web site<sup>1</sup> (the **Initial Industry Submissions**).

The purpose of this letter is to provide initial comments on several of the key themes identified in the Initial Industry Submissions, and also to further clarify a number of points raised by respondents. We understand that the Initial Industry Submissions only provide initial views from respondents, and that the issues raised in these submissions do not represent all the matters that will be raised in the course of the ACCC's assessment of NBN Co's SAU or a complete articulation of those matters raised.

This letter also does not provide NBN Co's final position on any of the issues discussed, but rather outlines our current thinking in relation to these matters, which NBN Co provides with a view to assisting the ACCC in its consideration of the SAU, and respondents in understanding the SAU (including its interaction with the WBA). This letter supplements and should be read together with NBN Co's Supporting Submission<sup>2</sup> that was provided to the ACCC on 20 December 2011.

#### ***SAU context and interaction with the WBA***

As described in NBN Co's Supporting Submission, NBN Co has designed the SAU as a package of commitments that seeks to provide an appropriate degree of regulatory certainty for access seekers, end users and NBN Co, as well as to facilitate the achievement of uniform national wholesale pricing.

NBN Co has consistently expressed its intention to set out terms and conditions of access to its services using both a SAU (if accepted) and a SFAA, currently NBN Co's Wholesale Broadband Agreement (**WBA**) and the legislative framework supports this approach. NBN Co believes that the structure of its

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<sup>1</sup> As at the time of writing this letter, responses had been published from Herbert Geer Lawyers (for iiNet, Internode and TransACT), Macquarie Telecom, Nextgen Networks, Optus, Telstra VHA and the CCC (although the CCC's response does not disclose which members the CCC is representing in its response).

<sup>2</sup> *Supporting Submission - NBN Co Special Access Undertaking*, 20 December 2011, available at: <http://www.accc.gov.au/content/index.phtml/itemId/1020185>



SAU, coupled with the WBA, addresses and balances the interests of access seekers, their end users and NBN Co.<sup>3</sup>

As discussed in NBN Co's Supporting Submission, the SAU is intended to provide the industry with certainty about the manner in which NBN Co will operate over the longer term. Its purpose is to set out controls around the critical aspects of pricing, expenditure, NBN Co's return on investment and to regulate key aspects of the supply of NBN Co's wholesale-only products and services across NBN Co's network technologies.

The SAU and the WBA have been drafted so that they are complementary, capable of operating together (ie for NBN Co to comply with both the SAU and the WBA)<sup>4</sup> and are designed to ensure visibility and oversight of NBN Co's activities by the ACCC in the manner contemplated by the legislation, whilst preserving flexibility to innovate and adapt as technology and customer needs change over the longer term.

The complementary SAU/WBA model developed by NBN Co also allows for NBN Co's customers to agree terms and conditions as set out in the SFAA (forming 'reference' terms of supply visible to the ACCC and access seekers), or seek to vary those terms and conditions following bilateral negotiations (subject to NBN Co's non-discrimination obligations, further supported by the transparency requirements to lodge with the ACCC all executed access agreements and a statement of difference comparing NBN Co's SFAA and any executed access agreement that differs from the SFAA). NBN Co's model also delivers protections to customers via consultation processes and access to the ACCC in respect of those terms NBN Co may seek to introduce during the term of a WBA.

The significance of the regulatory function of the WBA and its intended interaction with the SAU appears worthy of further consideration, explanation and discussion within the industry. The Contract Development Process that NBN Co has committed to conducting under the short term WBA provides an appropriate context in which to further discuss change management of the WBA over time.<sup>5</sup>

As the SAU cannot be accepted before NBN Co supplies services, and as NBN Co can only supply services that have been declared via the publication of a SFAA, NBN Co has published the WBA as a SFAA in advance of the SAU assessment being finalised.

As noted above, the SAU and WBA are currently aligned and NBN Co intends that they remain so. However, NBN Co has sought to provide maximum certainty to access seekers by the provision of alignment clauses in the WBA which ensure that the WBA can continue to reflect the SAU, should it be altered before it is accepted, and shortening the term of the WBA to one year to align it with the potential SAU assessment timeframe (noting that the assessment timeframe is a matter for the ACCC and not within NBN Co's control). In response to customer feedback, NBN Co amended the terms of its proposed alignment clause to ensure that its customers were provided with the discretion to update their WBA following the acceptance of the SAU or to leave their present agreements unvaried.<sup>6</sup>

It is also important to recognise that the SAU does not operate in a vacuum, but rather forms part of a wider set of regulatory constraints that apply to NBN Co. The ACCC has considerable powers under Parts IV, XIB and XIC of the *Competition and Consumer Act 2010 (CCA)* to regulate NBN Co's behaviour, and also has significant information gathering powers which would enable the ACCC to seek information above and beyond the extensive information to be reported under the SAU, should the ACCC consider that to be necessary. NBN Co is also subject to extensive parliamentary and other oversight of its operations.<sup>7</sup>

<sup>3</sup> For a discussion of NBN Co's engagement with industry and the ACCC see *Supporting Submission - NBN Co Special Access Undertaking*, 20 December 2011, pp.9-15.

<sup>4</sup> For further discussion of the interaction of the SAU and WBA, see *Supporting Submission - NBN Co Special Access Undertaking*, 20 December 2011, pp.74-78.

<sup>5</sup> NBN Co refers to the constructive discussion held with representatives of Optus, AAPT, iiNet, Internode, TransACT, Macquarie Telecom, Vodafone Hutchison Australia and iPrimus (and observed by the ACCC and the Department of Broadband, Communications & the Digital Economy) on 9 February 2012.

<sup>6</sup> See Module F, clause F.3 of the Wholesale Broadband Agreement, 30 November 2011.

<sup>7</sup> *Supporting Submission - NBN Co Special Access Undertaking*, 20 December 2011, pp.127-139.



## **Specific issues raised in Initial Industry Submissions**

The following specific issues, raised in Initial Industry Submissions, are addressed below:

- 1) ACCC's role in assessing the SAU
- 2) ACCC oversight
- 3) Term of the SAU
- 4) Price controls and price terms
- 5) Long Term Revenue Constraint
- 6) WACC
- 7) Prudence of Expenditure
- 8) Reporting
- 9) Other matters

### **1) ACCC's role in assessing the SAU**

A number of the Initial Industry Submissions express views as to the scope or nature of the ACCC's assessment which appear to go beyond the parameters of the legislative framework for the assessment of the SAU.

The ACCC's Consultation Paper sets out the legislative framework in the CCA and the considerations the ACCC must have regard to determining whether to accept or reject NBN Co's SAU, including the following:<sup>8</sup>

- The ACCC must not accept a SAU unless the ACCC is satisfied that the terms and conditions of the SAU are consistent with Category B SAOs and are reasonable;
- The ACCC is not required to be satisfied that price-related terms and conditions are consistent with the Category B SAOs, or are reasonable, if these price-related terms and conditions are reasonably necessary to achieve uniform national pricing of eligible NBN services; and
- The ACCC is also not required to be satisfied that terms and conditions are consistent with the Category B SAOs, or are reasonable, if the terms and conditions relate to certain conduct by NBN Co (relating to interconnection and bundling of access services) that is authorised under Part XIB of the CCA.

In considering whether terms and conditions are reasonable, the ACCC noted in its draft decision on FANOC that it is required to determine whether the terms and conditions of an undertaking are *reasonable*, not whether they are the best possible or whether they could be improved.<sup>9</sup> This approach is supported by the Australian Competition Tribunal.<sup>10</sup>

The ACCC's role in assessing NBN Co's SAU, including the matters to be considered in determining whether to reject or accept the SAU, are well defined in the CCA. Accordingly the SAU assessment process is not the appropriate context to debate the merits of broader policy and legislative settings.

### **2) ACCC oversight**

Macquarie Telecom's submission expressed a concern that the SAU proposes to dictate how the ACCC can make decisions and resolve disputes, and likewise Optus comments that "*It is concerning, therefore, that the SAU seeks to place restrictions and limitations on the ACCC's powers to regulate access to the NBN.*"<sup>11</sup>

In fact the SAU does quite the opposite. The powers conferred on the ACCC by the SAU are in *addition* to the existing powers the ACCC has under the CCA as now amended.<sup>11</sup> When the SAU confers a power

<sup>8</sup> NBN Co Limited Special Access Undertaking Consultation Paper, December 2011, pp.14-15.

<sup>9</sup> *Assessment of FANOC's Special Access Undertaking in relation to the Broadband Access Service – Draft Decision*, December 2007, p.30

<sup>10</sup> *Telstra Corporation Limited* [2006] ACompT 4 at [150].

<sup>11</sup> CCA section 152CBA(10A).



(eg Regulatory Recourse (Clause 6), or the review of POI locations (Clause 6 of Schedule 11)), it is appropriate for the SAU to define with as much precision as possible how these powers will operate, as there is no existing process for them. This does not take away from any existing powers of the ACCC, and provides additional regulatory safeguards for access seekers.

In addition to conferring decision-making powers on the ACCC in certain circumstances, the SAU also builds in a number of review mechanisms that have an explicit role for the ACCC and these reviews seem to have been overlooked in the Initial Industry Submissions. These include:

- Every 5 years, a review of the operation of the customer engagement process and the product development process;
- At around the time of any sale of NBN Co (or no later than 2027 if the sale process has not commenced), a review of key elements of NBN Co's approach to prudence of expenditure, inputs to the RAB and WACC, along with other relevant matters. This review will lead to NBN Co lodging a SAU variation, which will then be assessed by the ACCC.

These reviews are discussed in more detail on pages 91-93 of NBN Co's Supporting Submission.

### **3) Term of the SAU**

As discussed in NBN Co's Supporting Submission (pages 70-74), NBN Co has submitted a 30 year SAU to provide regulatory certainty for NBN Co and access seekers. Amongst the reasons outlined in the Supporting Submission for this approach are:

- The long payback period associated with NBN Co's investment;
- The long lifetime associated with the initial stock of NBN Co's investment;
- Long-term infrastructure arrangements entered into with Telstra; and
- Ensuring that the 'rules of the game' remain consistent in the transition from the 'loss making' period to the period in which the losses are able to be recovered.

While the SAU does have a long term, this is reflected in the overall design of the SAU proposed by NBN Co:

- The SAU sets the framework for regulation of access, with the WBA describing the detailed terms and conditions for access;
- Changes to the WBA that involve price terms or any non-price terms not covered by the SAU are subject to regulatory recourse to the ACCC, ensuring that as terms of access evolve over time, the ACCC will play a role in disputes relating to the WBA;
- The customer engagement model and operation of the Product Development Forum are subject to review every five years;
- The overall SAU arrangements are subject to review prior to any privatisation.

NBN Co has considered the option of using a shorter-term SAU accompanied by fixed principles terms and conditions that could carry over to subsequent undertakings. However, that option would not address NBN Co's need for certainty in the arrangements to recover initially incurred losses. Fixed principles can only carry over to a subsequently accepted SAU – if a future SAU is not accepted, the "certainty" provided by the "fixed" principles evaporates at that point in time.

### **4) Price controls and price terms**

In relation to comments from Telstra on the SAU's approach to pricing, NBN Co notes the following:

- While the initial "price freeze" commitments made in the SAU relate to the Basic Access Offers, CVC offer and NNI offer, these products constitute a significant proportion of NBN Co's revenues based on current Corporate Plan assumptions. In addition, the prices for other product components are already specified in the Price List of the WBA and have validity periods which should extend beyond the acceptance date of the SAU. All of these products would therefore be



subject to the CPI/2 price control, which means that all products in the WBA's Product Catalogue will be under price controlled arrangements once the SAU is accepted.

- As discussed in NBN Co's Supporting Submission (pages 54-55), and as noted by Telstra (page 12 of its submission) the initial prices of any new product components or product features will be constrained (amongst other things) by the anchoring effect of all the existing product prices, which will already be subject to price controls.
- The initial prices of new products not already covered by the WBA prior to the commencement of the SAU are subject to the Regulatory Recourse clause of the SAU, which provides a role for the ACCC to deal with disputes in relation to these prices before execution of an access agreement.
- As discussed in the Supporting Submission (page 49), NBN Co's pricing strategy is built on the assumption that, over time, telecommunications networks will increasingly be used for applications which substitute for services provided today through other mechanisms (e.g. health, education, entertainment, work). As users increase their utilisation of the NBN and derive a variety of benefits, they will be willing to pay for this increased utility. The increased usage of the NBN will also potentially lead to cost substitution for users of those services as activity moves to the NBN from other channels. This will be reflected in an increasing monthly revenue stream to NBN Co, even as prices fall in line with Corporate Plan assumptions.
- In the example provided by Telstra, which assumes NBN Co would increase CVC by the maximum allowed (CPI/2), the effect of such price increases on the level of demand does not appear to be addressed. NBN Co's Corporate Plan (page 103) states an expectation that the CVC price will decline from \$20/Mbps/month to \$8.75/Mbps/month over the period between 2011/12 and 2024/25, based on expectations of increased usage over time. Using the increasing price scenario described by Telstra would presumably result in lower usage growth, and hence lead to substantially lower ARPU outcomes than those described in Telstra's submission.

More generally, it is important for all stakeholders to understand that the pool of costs that NBN Co needs to recover over time will be largely fixed in nature and NBN Co has had to strike a balance across a range of competing priorities in setting its pricing strategy. If one part of that pricing strategy were to be changed, for example the starting level or time profile of CVC charges, then this would need to be balanced in terms of its revenue impact by a change to other parts of the strategy, such as to the starting level or time profile of AVC charges.

Similarly, if individual product pricing was required to be tied only to the recovery of the cost of the specific components of any specific product, as suggested by Telstra, then NBN Co would not have the flexibility required to balance its key priorities such as, for example, uniform national wholesale pricing, broad take-up and affordability of the service, and efficient recovery of costs.

In addition, as highlighted in the Supporting Submission (page 49), having the flexibility to dynamically adjust the pricing strategy is very important for NBN Co, access seekers and their end-users given the extent of the economies of scale and scope associated with the NBN and also the need to account for evolving technology, applications and demand over the 30 year term of the SAU. The SAU both provides NBN Co with appropriate flexibility in this regard and, via the CPI/2 Price Control, provides access seekers and their end-users with the certainty that all of NBN Co's prices will decrease in real terms in each year of the SAU term, subject only to limited exceptions.

## **5) Long Term Revenue Constraint**

Macquarie Telecom commented that there should be consistency between the approaches adopted in the SAU and in previous approaches that have been adopted by the ACCC. Our approach is based on those adopted by the ACCC for a number of regulated industries and also reflects the methodology used by the AER. A key difference is the inclusion of the ICRA mechanism, which deals with the fact that we will not be in the same 'steady state' operation as other regulated entities for a number of years.

A number of Initial Industry Submissions commented on the relevance of the LTRCM, given that it may not apply for many years. However, this element of the SAU does not operate in isolation. Importantly, the LTRCM forms only one component of the suite of measures that guide the long term price evolution of NBN Co's products. The LTRCM ensures that NBN Co can do no more than recover its efficiently incurred costs, which will ultimately flow into the prices it can set for its products. This means that NBN



Co is not able to “over-recover” its efficient costs of supply. In the period where these costs have not yet been recovered (and hence where, demonstrably, its prices do not exceed its long term costs), the other factors that come into play in how NBN Co’s prices can be set include:

- Initial pricing commitments on the Price Controlled Offers;
- CPI/2 price control, which will apply to *all* products and services that are currently in the WBA, from the commencement date of the SAU;
- The anchoring effect of those existing prices on any initial prices for new products; and
- The Regulatory Recourse clause of the SAU, which provides a role for the ACCC in the case of disputes about new prices that are introduced.

Together, these features of the SAU, in conjunction with the LTRCM, are designed to provide long-term certainty that NBN Co’s prices will recover no more than its costs, including a return on capital.

Telstra has also suggested that without the support of a working building block model the LTRCM is “largely a theoretical construct” (p.13). The LTRCM is in fact a highly practical construct that, as noted above, is based on the building block approaches used by the ACCC and the AER in a range of other regulated industries. As compared to the previous Total Service Long-Run Incremental Cost (TSLRIC+) approach that was used to set access prices for fixed services in the telecommunications industry for the last decade or more, the LTRCM is firmly grounded in reality – it uses the (prudently incurred) actual capital and operating expenditure for all of NBN Co’s operations and provides a relatively simple and transparent mechanism for tracking over time NBN Co’s Regulatory Asset Base and Initial Cost Recovery Account. TSLRIC+ models, on the other hand, are based on theoretical cost models of hypothetical networks using best estimates of costs and service levels, which may or may not reflect the cost of supplying a service. Such limitations of these models have long been realised<sup>12</sup>, and the ACCC has recently “...moved from its previous hypothetical pricing approach (TSLRIC+), [and] ... has adopted a ‘building block’ approach”<sup>13</sup>. NBN Co’s use of a LTRCM is entirely consistent with this move away from a hypothetical pricing model to one that reflects the actual underlying costs of its network.

## 6) WACC

In relation to WACC, NBN Co would like to clarify one point raised in Telstra’s discussion of the issue. As defined in clause 7 of Schedule 7 of the SAU, the nominal vanilla WACC for a given financial year is equal to the mean yield on 10 year Commonwealth Government Securities (averaged over the final 20 Business Days of the preceding financial year) plus 3.50%.

The Officer and Bishop report states (p.14) that the average of yields on 10 year Commonwealth Government Securities over the 20 days to 22 November 2011 was 4.22%. If this average were taken as the risk free rate in the SAU then the resulting nominal vanilla WACC would be  $4.22 + 3.50 = 7.72\%$ , not the 8.6% calculated by Telstra in its initial submission (p.16). The significant difference is because Telstra has added 3.50% to Officer and Bishop’s estimate of the mean yield on 30 year government bonds rather than the mean yield on 10 year Commonwealth Government Securities (the former is an input into Officer and Bishop’s opinion as to what an appropriate WACC would be for NBN Co, while the latter is what is actually used in clause 7 of Schedule 7 of the SAU).

## 7) Prudence of Expenditure

NBN Co assumes that the ACCC will give careful consideration to the NBN Co Network Design Rules document, noting the intended purpose of the document and that the SAU has been formulated by reference to the network design NBN Co is implementing, as described in that document. NBN Co has designed its network to deliver the objectives expressed in the Government’s Statement of Expectations in an efficient and prudent manner, and as noted in our Supporting Submission<sup>14</sup>, NBN Co is subject to

<sup>12</sup> For example, “TSLRIC, TELRIC and other forms of forward-looking cost models in telecommunications: a curmudgeon’s guide”, Henry Ergas 1998 ([http://www.greenwhiskers.com.au/papers\\_reports/papers-ergas-tslric-final-nov98.pdf](http://www.greenwhiskers.com.au/papers_reports/papers-ergas-tslric-final-nov98.pdf)) states “...the models reviewed are littered with short-cuts and assumptions that limit their validity” (p.25).

<sup>13</sup> ACCC, “Inquiry to make final access determinations for the declared fixed line services – Final Report”, July 2011, p.9.

<sup>14</sup> Supporting Submission - NBN Co Special Access Undertaking, 20 December 2011, pp. 127-139.



significant transparency and external oversight measures by virtue of its status as a Government Business Enterprise.

## 8) Reporting

NBN Co notes that the reporting commitments that are made in Schedule 10 of the SAU are in *addition* to the general powers that the ACCC has to request information from NBN Co. That is, the reporting commitments do not limit the ACCC's powers or discretion to obtain information which it believes necessary to ensure that NBN Co is compliant with the terms of the SAU.

## 9) Other matters

A number of other issues were raised in the Initial Industry Submissions which were only identified by a single respondent, and NBN Co's initial comments on these issues are as follows:

- **UNI Availability** - Macquarie Telecom identified that clause 6.5 of Schedule 3 makes supply of a service conditional on access to a UNI, and expressed a concern that a single access seeker could acquire all UNIs at a premises, thus blocking other retail service providers. NBN Co notes that while this is a technical possibility, it does not believe that this approach would be commercially attractive to an access seeker, as it would require them to acquire four entry-level services at a total minimum monthly cost of \$96 (4 x \$24). In any case, in order to avoid the potential for widespread application of such a strategy, section 4.8 of the WBA Product Catalogue contains prohibitions restricting such behaviour.
- **Scope of Services/products** – Nextgen Networks expressed a concern that NBN Co may provide services beyond its intended scope, and that the ACCC should have regard for potential impacts on related markets. The SAU covers only Layer 2 services from a UNI to an NNI at an NBN Co POI. If NBN Co attempted to provide a service beyond that defined scope, it would need to lodge either a new SAU or seek a variation to the existing one, or modify the WBA (which would invoke Clause 6 of the SAU). The Product Development Forum processes also provide an open and transparent mechanism for concerns about new product development to be raised by industry participants. In any such case, the ACCC would have a clear role.
- **Product element definition** – Telstra identified a concern with the level of certainty on the full scope of the “product package” offered by NBN Co (page 23 of its submission). The WBA contains very detailed descriptions that define the product and service. Contractual commitments have also been provided in relation to improved service levels as core systems come on line, and each customer is provided with access to the Contract and Product Development fora to enable customers who choose to do so to make a contribution to the further enhancement of product offerings or commercial terms.
- **POI locations** – Macquarie Telecom raised the issue of the ACCC's role in approving POI locations, and expressed a concern that NBN Co is dictating how the ACCC can make decisions on them. However, as discussed above, the SAU in fact confers additional powers on the ACCC beyond those it already has, and allows for the ACCC to approve or reject any requests by NBN Co to close, locate or open POIs. The ACCC is also able to consult with any person in making a decision on a POI location (Clause 6.6 of Schedule 11).

Please do not hesitate to contact me if you have any queries in relation to the information provided. NBN Co requests that this letter be placed on the ACCC's website together with the Initial Industry Submissions.

Yours sincerely,

A handwritten signature in blue ink that reads "Caroline Lovell".

**Caroline Lovell**  
Principal, Regulatory Affairs and Industry Engagement