Optus Submission

NBN Co Discussion Paper

Introducing NBN Co's Special Access Undertaking

August 2011

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Section 1. Introduction

1.1 This paper provides Optus' comments on NBN Co's discussion paper on its proposed Special Access Undertaking (SAU), which was released in July 2011 (Discussion Paper). Optus notes that these are preliminary comments based on material set out in the Discussion Paper. Optus may have further comments once it has had visibility of the actual SAU.

1.2 Optus welcomes the opportunity to provide comments to NBN Co ahead of it finalising the SAU. However, given the importance of this instrument and the imminent launch of commercial services on the NBN, it would have been helpful for NBN Co to have consulted the industry earlier.

1.3 In this respect we note that the SAU will have a fundamental role in determining the rights, obligations and interaction between NBN Co, the Australian Competition and Consumer Commission (ACCC) and Access Seekers over a lengthy period. It will have a significant long-term influence on the business models of retail service providers and the state of competition in the fixed line market. Given this, it is important that there is very careful and detailed consideration of the SAU prior to the commercial launch of services.

1.4 It is somewhat concerning that access seekers will be put in the position of having to potentially sign an access agreement not only before the SAU has been approved, but before it has even been lodged with the ACCC for approval.

Executive summary

1.5 Optus submits that the SAU described in NBN Co's discussion paper is not one that is likely to receive ACCC approval. The SAU, as described, gives insufficient consideration to NBN Co's likely position in the market. It also fails to acknowledge the very recent and long debate within the industry on the need for a very different regulatory framework over the fixed line sector. Structural separation alone is insufficient to ensure a competitive fixed line telecommunications sector with pricing outcomes that are in the long term interests of end users. Given NBN Co's status as a monopoly supplier, strict ACCC oversight is also required, particularly with respect to pricing.

1.6 The key concerns this submission will raise with the proposed NBN Co SAU are as follows:

(a) The proposed term of 30 years is as unprecedented as it is unreasonable;

(b) The proposed pricing arrangements provide far too much discretion and flexibility to NBN Co and will almost certainly lead to future price rises above inflation. Prices should be subject to much tighter and more frequent ACCC oversight;

(c) The proposed mechanisms to protect against "price shock" will do nothing of the sort. They can very easily be circumvented and are an open invitation for prices to rise;

(d) NBN Co's proposed treatment of the WACC is not reasonable. The use of a very high WACC in the early years of the project implies that the risk of failure of the project is so high it could be considered near certain;

(e) Whilst NBN Co has recognised that the efficiency of its costs is likely to be a 'key issue' for access seekers and the ACCC, its proposals to safeguard this objective are not fit for purpose. NBN Co has largely accorded itself the ability to 'roll-in' all build costs with little or no scrutiny other than by adopting high level 'principles; and

(f) There appears to be insufficient ACCC oversight of the key non-price terms and conditions of access. It appears that other than some high level principles the key terms and conditions of access will be left to the WBA, which will be subject to no ACCC oversight.

Section 2. Overview of the Proposed Framework

NBN Co's position in the market

2.1 Optus supports the roll-out of national high-speed broadband infrastructure. But to ensure that the benefits of such infrastructure can be fully realised it will be important to get the regulatory setting right. In particular, these must help to both facilitate the investment and to set a platform for a vigorous and competitive retail sector to emerge.

2.2 In this respect, it is important to note that NBN Co will be the operator of the only ubiquitous highspeed broadband infrastructure in Australia. Once Telstra's copper loop is decommissioned, NBN Co is likely to face little or no infrastructure based competition over much of its footprint. In fact competition will be discouraged by the "anti-cherry-picking" provisions of the recently enacted NBN Access Act 2011.

2.3 In this environment NBN Co will have extensive market power. To provide fixed line services to their end-customers, Retail Service Providers (RSPs) will have no option but to source access services from NBN Co. The prices, terms and conditions NBN Co will set for those access services will, therefore, have a profound and direct impact on the economics of supply of those RSPs and ultimately the prices paid by end-users.

2.4 Given its position in the market, it is appropriate that NBN Co is tightly and transparently regulated.

2.5 Optus submits that the SAU envisaged in the Discussion Paper does not have appropriate regard to NBN Co's position in the market. As will be detailed in the submission, it appears that in some key areas the SAU provides too much discretion to NBN Co and insufficient oversight powers to the ACCC. Given its status as a monopoly service provider, it is disconcerting that NBN Co believes it should have the level of discretion it has proposed.

Hierarchy of Terms

2.6 As noted in the Discussion paper, the recent amendments to the Competition and Consumer Act have given precedence to access agreements over other regulatory instruments, including Special Access Undertakings. The industry raised concerns with this provision during the consideration of the regulatory package, specifically that it could operate to deny access seekers the ability to obtain the benefit of regulatory decisions.

2.7 In the context of the NBN, this risk is heightened because access seekers are likely to be in the position of having to sign NBN Co's Wholesale Broadband Agreement (WBA) ahead of the SAU being approved by the ACCC.

2.8 To mitigate this risk Optus will seek an amendment to the current draft of the WBA to ensure that by signing the WBA we will not fetter our rights to take advantage of any regulatory instrument. We will be seeking such a commitment from NBN Co as an amendment to the WBA and ensuring this principle is recognised in the SAU.

Duration of SAU

2.9 NBN Co has indicated that it will seek a 30 year term for the SAU on the basis that this will "provide sufficient regulatory stability over both a substantial part of the life of the key network assets, and the expected payback period of the initial investment, as well as ongoing prudently incurred costs".[1]

2.10 Whilst Optus appreciates the need for some longer-term certainty around the regulatory framework, we believe the proposed period is unreasonable. Such a period would be unprecedented. More importantly it risks locking the industry into a set of regulatory arrangements that may become outdated and unresponsive to the market conditions and the needs of end-users.

2.11 It is worth noting that since 1997, there have been several quite fundamental changes to the telecommunications regulatory framework to deal with issues or circumstances that were not envisaged at that time.

2.12 We note that in respect of the SAU put forward by the G9 consortium, which proposed a period of 15 years, the ACCC expressed some clear concerns with the proposed period of that SAU

> *The ACCC does, however, have concerns as to whether it can be satisfied that the specific terms and conditions of access in FANOC's SAU, if applied over 15 years, will continue to promote competition and remain in the interests of access seekers.*[2]

2.13 Optus submits that these same concerns will also be relevant to NBN Co's SAU.

2.14 Optus acknowledges that investors in infrastructure have a legitimate claim for some level of regulatory certainty in respect of the arrangements that will apply to that investment. However, the usual purpose of promoting such certainty is to encourage commitment of capital by private sector investors. In the case of the NBN, the investment will be fully funded by Government, so it is questionable as to whether the standard should apply. Further, the SAU cannot eliminate the ultimate uncertainty NBN Co faces from a three year electoral cycle.

2.15 Optus submits that whilst it would be appropriate for the SAU to have a term beyond the usual three year duration for ordinary access undertakings, this term should be significantly shorter than that proposed by NBN Co. At the very most this term should not extend beyond the anticipated build phase of December 2020.[3]

Other comments

2.16 At pages 9 and 10 of the Discussion Paper, NBN Co lists certain factors the ACCC has identified that should have regard to in designing the SAU. One of these relates to NBN Co's right to unilaterally change fundamental terms and conditions of access. In particular, NBN Co notes the ACCC's position to be that:

> *Regarding changes to terms and conditions over time, for terms which describe fundamental relationships between the parties, there should not be a power that allows unilateral amendments by NBN Co. Such changes should require agreement between NBN Co and access seekers. All changes should be made with sufficient notice for*

[1] NBN Co, *NBN Co discussion Paper: Introducing NBN Co's Special Access Undertaking*, July 2011, p.13

[2] ACCC, *Assessment of FANOC's Special Access Undertaking in relation to the Broadband Access Service*, Draft Decision, December 2007, p.102

[3] NBN Co, Corporate Plan 2011-2013, 17 December 2010, p.22

consultation (notice periods may vary depending on the nature of the change) and consideration of responses by NBN Co in good faith.[4]

2.17 Optus strongly agrees with this comment. This principle should be set out both in the proposed SAU and NBN Co's WBA.

[4] NBN Co, *NBN Co discussion Paper: Introducing NBN Co's Special Access Undertaking*, July 2011, p.10

Section 3. Price Commitments and Long Term Revenue Constraints

3.1 The essential purpose of the NBN is to deliver competition and in turn, *lower* prices. Indeed, the NBN Co business plan and the Government have stated that prices will decline and be affordable.[5] The SAU must ensure these obligations are met. More importantly, the ACCC will assess the SAU against the criteria contained in the *Competition and Consumer Act 2010*, specifically paragraph 152BCA(1)(a). This states that in making a decision the ACCC must be satisfied that it is in the long term interests of end-users (LTIE), of which the ACCC has stated:

> *In the ACCC's view, particular terms and conditions promote the interests of end-users if they are likely to contribute towards the provision of:*
>
> - *Goods and services at **lower prices***
> - *Goods and services of a high quality, and/or*
> - *A greater diversity of goods and services.*[6] *[emphasis added]*

3.2 The Australian Competition Tribunal has expressed a similar view on the legislative criteria, it stated that:

> *…the **interests of the end-users lie in obtaining lower prices** (than would otherwise be the case), increased quality of service and increased diversity and scope in product offerings…"*[7] *[emphasis added]*

3.3 Optus considers that NBN Co's price commitments and revenue constraints have serious shortcomings in terms of meeting these primary goals. Further, the Discussion Paper describes a number of principles which are to be included in the SAU in relation to the prices that NBN Co will charge and the associated revenues it can earn. In making these statements NBN Co has asserted that:

> *NBN Co is acutely aware of access seekers' requirement for **long term price certainty** and the need for NBN Co's pricing to be set at a level that **encourages end-user take up**.*[8] *[emphasis added]*

3.4 Optus has serious misgivings regarding the extent to which these two significant requirements have been taken into account in NBN Co's SAU pricing arrangements. This is because when the proposed arrangements are viewed in the context of the existing operating environment, where prices have been *falling*, the inherent expectation presented by NBN Co that prices will be rising in fact creates significant *uncertainty*. Furthermore, the price structures and levels will not encourage take-up, given the focus on usage and the higher starting prices compared to existing prices.

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[5] NBN Co, *Corporate Plan 2011-2013,* 17 December 2010, pp.100-104; and Joint Media Release with the Hon Julia Gillard MP Prime Minister and Senator the Hon Penny Wong Minister for Finance and Deregulation and Senator the Hon Stephen Conroy Minister for Broadband, Communications and the Digital Economy, "Government release NBN Co Corporate Plan", 20 December 2010.

[6] ACCC, *Telecommunications services – declaration provisions: a guide to the declaration provisions of Part XIC of the Trade Practices Act*, July 1999, p.33

[7] *Seven Network Limited (No 4)* [2004] ACompT 11 at [120]

[8] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking*, July 2011, p.22

3.5 Below Optus describes these shortcomings and concerns in relation to each of the following elements from NBN Co's Discussion Paper:

(a) the overall approach to the form of regulation;

(b) operation of the price commitments;

(c) operation of the long term revenue constraint; and

(d) the price shock mechanism.

3.6 In summary, Optus considers that the proposed pricing arrangements which will almost certainly lead to price rises are wholly unreasonable and unbecoming to a company in NBN Co's position. Reflecting NBN Co's position as a licensed monopoly facing no competition the price arrangements need to be subject to much tighter ACCC oversight.

Overall approach to the form of regulation

3.7 NBN has presented an hierarchy of constraints that consists of:

(a) Price controlled offers (PCOs) which are ceiling prices for the first five years on a limited set of products;

(b) Weighted average basket price control which limits the overall price change on a limited set of products following the first five year period;

(c) Price shock mechanism that limits the price change on any product to CPI+5%; and

(d) An overall revenue cap which constrains the total revenues which NBN Co can earn across all its products and services.

3.8 Tellingly, the most important constraint on NBN Co – the constraint on its overall earnings – will not affect the level of prices it can charge when rollout is occurring and until the initial cost recovery account (ICRA) is extinguished.

3.9 The ICRA is also likely to be very large. This is because NBN Co has very large operating expenditures as it is leasing ducts and backhaul from Telstra. Secondly, the WACC is high in early years, thus unrecovered allowed revenues that are added to the ICRA will be escalating at a high rate of interest. This substantial size of the ICRA means that it is likely to operate for some time. Further, during the period in which the ICRA is in operation NBN Co appears to have complete flexibility to raise revenues to any level (short of a level that would extinguish it). This means that the revenue constraint will have *no* constraining effect on prices NBN Co can charge for the first 15 years of operation (at least).

3.10 The only remaining control on prices (and revenues) are the limited price basket and the price shock mechanism under which NBN Co seeks the right to impose an arbitrary increase of up to CPI + 5% on access seekers.

3.11 These arrangements practically guarantee that prices will rise over the term of the agreement – and by a significant degree – which is contrary to the LTIE and not in the interests of the consumers or businesses that will use the NBN's services. It also appears to be in contrast to the Minister's expectations, as the *Australian* reported that:

Communications Minister Stephen Conroy said last night that NBN Co's corporate plan said that prices would fall in real and nominal terms. "I expect them to deliver on their corporate plan," he said.[9]

3.12 Moreover, rising prices discourage take-up and potentially affects retention. A trend of rising prices for fixed products in the context of exponential improvements in wireless technology has the potential to dislodge end-users from the NBN. NBN Co therefore needs to consider more than just end-user take-up, but end-user retention in order to deliver the required return on investment. This consideration appears to have been overlooked by NBN Co except to highlight the demand uncertainty it will face to justify the ability to *increase* prices.

3.13 The only way to satisfy the interests of consumers and businesses in lower prices, provide price certainty and encourage take-up is to limit price changes on all products offered and to link NBN Co's incentives to earn revenues with increased usage of its network. It is therefore Optus' proposal that a weighted average price cap should be applied to control the prices of *all* NBN Co's products and services. The overall price cap should be limited to less than CPI. This means since there is no limit on how much revenue NBN Co can earn – only a limit on what prices it can charge – NBN Co will be incentivised to keep prices low and encourage increased network usage.

3.14 The price cap should operate in this manner until the ICRA is extinguished, after which the overall change in the price cap could be linked with the change in the calculated revenue requirement. Incentives could also be built into the overall price change for quality of service (QoS) improvements – meaning that should NBN Co be able to make demonstrable improvements in measureable quality indicators, additional price rises could be permitted.

3.15 The operation of any price control should be subject to frequent ACCC review (preferably annual review) to ensure that it is operating in a manner that is consistent with the long term interests of end-users (LTIE). A useful model in this regard is the rule for pricing of regulated services by electricity distribution network service providers (DNSPs). DNSPs' pricing is subject to a revenue cap with an annual weighted average price cap. However, DNSPs do not have absolute flexibility to implement price changes within these constraints. In addition, every year (prior to 1 July), the DNSP is required under Chapter 6 of the National Electricity Rules[10] to submit to the AER a pricing proposal which sets out proposed prices for all of its regulated services for the forthcoming financial year. The AER assesses the proposal and approves it only if all proposed price changes to relevant services are reasonable and consistent with the Electricity Rules, including the determined revenue requirement and the specific pricing rules. Further, the Pricing Rules set out a number of requirements in terms of, for example, the classification of services, limits on price increases and pricing principles.

3.16 Alternatively, NBN Co could publish a rate card – list of all prices – that is annually approved by the regulator. However it is presented, Optus believes that NBN Co should not be accorded such a high degree of pricing flexibility when the project is in its infancy and take-up is a primary goal. Strict pricing discipline is important for the ultimate success of encouraging consumers to take-up and ultimately utilise the NBN.

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[9] Heporth, Annabel, "NBN cost to 'widen the digital divide'", *The Australian*, 23 August 2011

[10] *National Electricity Rules Version 45*, available from the AEMC's website - http://www.aemc.gov.au/Electricity/National-Electricity-Rules/Current-Rules.html

Operation of the price commitments

3.17 Subject to Optus' objection of the overall approach to the form of regulation, comments on the specific arrangements are provided below.

Initial regulated prices

3.18 NBN Co has proposed to limit the maximum price charged on three key products for the first five year period. However, the products included in the initial PCO do not adequately represent the range of products required by industry and so are unlikely to drive take-up and use of the NBN. The PCO is therefore insufficiently comprehensive to ensure the LTIE are promoted.

3.19 Firstly, it is concerning that the PCO does not include a video (multicast) offering. Video is a key component in what is known as 'triple play' and is likely to become very important for its contribution to average revenue per user (ARPU) and reducing customer churn (increasing retention). This was highlighted by the ACCC in the recent consideration of the FOXTEL/AUSTAR merger:

> *Market inquiries have highlighted the likely importance in the future of telecommunications and broadband competitors being able to provide a bundle of three or four services to consumers. Such a bundle includes fixed voice, broadband internet, television and in some cases, mobile telephony services. The role of subscription television services providers (and the content they can offer) is seen as key to providing such a bundle. Market inquiries indicated the importance of being able to provide a bundle of services is becoming increasingly important over time, particularly once the NBN is rolled-out.*[11]

3.20 The importance of video take-up and usage is also understood to have underpinned the justification and business case for the NBN itself. Clearly, the PCOs should include a video product.

3.21 Secondly, it is unreasonable to include only one speed (the minimum speed) in the PCO. Strict pricing discipline on higher speed products will be integral in order to promote competition, particularly in the enterprise market. Moreover, the promise being made to the country is that the NBN will deliver *super*fast broadband, not status quo broadband. Therefore, higher tiered products should be included in the PCO in order to deliver on this promise. Furthermore, it is not prudent to exclude the 'anchor' product from review for the first five years. This assumes that NBN Co can accurately predict technological change and consumer appetite for higher speeds. It is likely that 12 Mbps will be superseded before five years has passed.

3.22 Thirdly, Optus, and other relevant parties, have raised significant concerns with the CVC product construct. Optus is concerned that NBN Co's pricing structure is unlikely to promote prices that are considered reasonable and affordable by end-users. Contrary to NBN Co's expectations its pricing structure may act as a barrier to the take-up of higher speed access plans and the usage of data rich services and applications because of the high data usage fees built into its access fees. This issue was recently commented upon by Henry Ergas, writing in the Australian:

[11] ACCC, *Statement of Issues – FOXTEL-proposed acquisition of Austar United Communications Limited*, 22 July 2011, p.15

…service providers will pay the NBN both a monthly fee and a volume-related charge, even though data volumes barely affect the NBN's line costs.

And according to NBN Co's corporate plan, average consumer usage grows 30 per cent a year. So even were the current price per bit kept constant, the average monthly usage payment to NBN Co per household would rise from $1 in 2013 to more than $100 in 2028.[12]

3.23 Optus recommends that NBN Co rebalance the fixed and usage components of its proposed access charges to address these concerns.

<u>Basket approach</u>

3.24 A key concern for Optus regarding the ongoing basket construct is the frequency and criteria by which products are added to, and removed from, the basket. It is not sufficient to limit resets to solely the 'most popular' speed tiers of the original PCOs, as it may become apparent that another product entirely will be important to access seekers and end-users. It is therefore unacceptable that the ACCC has no role in determining the criteria for the second five year period after commercial services have launched.

3.25 Secondly, it is unnecessary to include provisions for unusually high CPI. This is because there are already two inherent mechanisms to ensure that NBN Co is not adversely affected by unusually high inflation:

(a) there is a long term inflation target for the CPI, which drives monetary policy. A more appropriate link to protect against high CPI would be to link the maximum CPI level with the upper bound of the target (which is currently 3%); and

(b) NBN Co is compensated for actual inflation in the weighted average cost of capital (WACC). This means that any unusually high inflation would be captured in the revenue requirement. The fact that NBN Co has proposed to include a provision for high CPI in the price controlled basket is indicative of the tenuous link the basket has with the revenue constraint.

3.26 Thirdly, the price shock mechanism is an arbitrary measure that if the form of price control were tighter, would be unnecessary. That is, if all NBN Co's prices were subject to a price cap, or the revenue cap acted as a real constraint, the price shock mechanism would not be required. This is separately discussed in more detail in the section below.

3.27 It should also be noted that any weighted average price cap approach should include regular reporting requirements to ensure compliance with the regime and promote transparency to access seekers. Optus supports NBN Co's commitment to provide relevant information to the ACCC to ensure it is meeting the requirements included in the SAU (further non-price commitments are discussed in section 5).

[12] Ergas, Henry, "The gouge is on for NBN users", *The Australian*, 26 August 2011

Operation of the long term revenue constraint

3.28 Optus has long been a strong advocate for regulated prices to facilitate the recovery of the access provider's efficiently incurred costs. It is therefore somewhat reassuring that NBN Co seeks to establish the annual regulated revenue utilising a building block approach.

3.29 The principles of a locked-in regulated asset base (RAB), ex ante approval of expenditure and providing incentives to incur costs efficiently are all appropriate. However, a key concern is the lack of initial scrutiny of the costs that will be locked into the RAB.

3.30 NBN Co's proposal to 'lock-in' a number of WACC parameters, or approaches to calculate parameters, is particularly concerning. It has the potential to result in significant over (or under) recovery of costs if 'benchmark' figures are wrong. For example, the efficient gearing level of NBN Co may be difficult to predict at this time.

3.31 These proposals will have serious long term effects if NBN Co overspends during the building phase. These are discussed in more detail in section 4. Below Optus presents specific comments on the WACC.

Weighted average cost of capital

3.32 NBN Co's proposed approach to determining the weighted average cost of capital (WACC) raises serious concerns.

3.33 The SAU attempts to define three different periods for the investment, with the WACC starting at an extremely high level in the first period and falling over the subsequent two periods. The rate of return NBN Co is proposing is expected to exceed 20 per cent in the early years[13], which is significantly higher than the rate access seekers are currently paying Telstra.

3.34 Optus considers that the high first-period WACC is inappropriate. NBN Co should receive compensation for the capital costs it has incurred, and no more. In this regard the key relevant fact is that the NBN is a public project funded by taxpayer funds. At the very most, the WACC should represent the Government's actual borrowing costs, that is, the Government bond rate (which is currently 5.02% pa for 10 year bonds)[14], not the WACC that would be required for a commercial project.

3.35 NBN Co's approach to the WACC appears to be inconsistent with Government's policy statements. For example, the Minister has stated that:

> *… we have never taken the approach that we need to make the rate of return that the telco sector is used to. This is a project which returns all of the government's money and interest costs, and makes a modest return of six to seven per cent.*[15]

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[13] NBN Co, *Corporate Plan 2011-2013,* 17 December 2010, p.143

[14] RBA, F2 Capital Market Yields – Government Bonds – Monthly (XLS file), (last updated 2 August 2011)

[15] Clarke, Trevor, "Conroy: NBN Co doesn't need regular telco commercial returns", *Computerworld*, 10 May 2010

3.36 Further, the Minister has stated that:

> *NBN Co's expected rate of return is 7.04 per cent, which compares favourably with the average 10 year bond rate (July 2009 to November 2010) of 5.39 per cent. The NBN Corporate Plan shows the Government can expect to recover all its funding costs with interest.*[16]

3.37 The impact of assuming a high initial WACC which falls in the future has the potential to materially increase the revenues of NBN (relative to a scenario where WACC is constant but has the same time weighted average value). The reason why having a high initial WACC increases global revenues is that the high initial WACC is used to compound unrecovered expenditures over the first two phases. The nature of high early compound interest is that it increases total interest costs over the life of the asset relative to a flat interest rate profile. The use of a high initial WACC to capitalise the unrecovered revenue will make the allowed revenue significantly exceed the actual costs incurred by NBN Co because the allowed return is greater than its actual cost of capital. This outcome is unlikely to be considered consistent with the legislative criteria.

3.38 The use of a high WACC in the early years also implies that the risk of failure in the early years of the project is so high it could be considered near certain. That is, the WACC has been set to assume that the NBN fails. This is clearly an unreasonable assumption and is underpinned by the fallacious idea that a government-owned company will emulate the risks of a commercial project.

3.39 Finally, Optus considers that the principle that NBN Co should be compensated for differing levels of risk for different commercial phases, similar to a commercial project, is unreasonable. The fact that Government policy has created the NBN in response to a lack of market delivery illustrates the very *un*commercial nature of the project. Moreover, the combination of Government backing and substantial market power practically guarantees that the risks facing NBN are *less* than that of other commercial projects. Optus submits that NBN Co should re-examine its entire approach to the cost of capital.

Price shock mechanism

3.40 The price shock mechanism – which allows for any price (apart from the PCOs in the first five years) to increase annually by up to CPI+5% is wholly unreasonable and allows for an excessively rapid rate of increase. Notwithstanding the fact that if overall price controls were stricter the mechanism would be unnecessary, a level much lower would appear to be more appropriate (eg CPI+2%).

3.41 The contrast with recent wholesale price trends provides the real shock: since 2000 the comparable wholesale products on Telstra's network have fallen 7 per cent annually in real terms.[17]

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[16] Joint Media Release with the Hon Julia Gillard MP Prime Minister and Senator the Hon Penny Wong Minister for Finance and Deregulation and Senator the Hon Stephen Conroy Minister for Broadband, Communications and the Digital Economy, "Government release NBN Co Corporate Plan", 20 December 2010.

[17] Ergas, Henry, "The gouge is on for NBN users", *The Australian*, 26 August 2011

3.42 It also appears that the mechanism can be circumvented by the terms in the WBA which note that NBN Co can withdraw and/or replace any product component with 12 months notice and any product with 24 months notice. NBN Co can circumvent the price control by simply withdrawing a speed tier and requiring customers to move up to a new higher cost speed tier. The effect of withdrawing a product could be to raise the price of products actually consumed by customers by more than CPI+5%. Imagine in a simple example that NBN Co had three products - a 12 Mbps product at $20, a 25 Mbps product at $30 and a 50 Mbps product at $40. Imagine inflation was 5%, allowing NBN Co to raise the price of its 25 Mbps product by 10% (or $3). However, if NBN Co were to instead withdraw its 25 Mbps product and more than half (say 60%) of customers shifted to the 50 Mbps product at $40 it could achieve a greater effective increase in prices. Alternatively, NBN Co could simply withdraw and replace its 25 Mbps product with one priced at greater than $33.

3.43 Optus submits that any product withdrawals and/or replacements should be subject to ACCC approval, in order to ensure that NBN Co does not use these options to circumvent the price shock mechanism.

Section 4. Prudency Arrangements

4.1 NBN Co has recognised that the efficiency of its costs is likely to be a 'key issue' for access seekers and the ACCC. However, despite this acknowledgement, NBN Co's attempts to address these concerns in its Discussion Paper appear seriously misguided. NBN Co has largely accorded itself the ability to 'roll-in' all build costs with little or no scrutiny other than by adopting high level 'principles'.

4.2 Optus submits that this approach is unacceptable and NBN Co should seriously reconsider its apparent preference for minimising ACCC scrutiny. Below Optus provides some initial comments on NBN Co's approach with respect to the following aspects:

(a) the network design rules – of which there are two elements: the initial rules; and the process to vary those rules;

(b) the prudent cost condition; and

(c) ongoing operating and capital expenditure forecasts.

Network design rules

Approval of network design rules

4.3 The network design rules are to set out guidelines to determine how the NBN will be built to meet the Government's policy directives. Whilst Optus recognises that it will be important to establish prudent design and governance arrangements, this should not supplant ongoing scrutiny.

4.4 NBN Co's approach appears to be rooted in an engineering driven mindset which is frankly uncommercial. In a properly run business, all capital projects are subject to rigorous cost control and review, which strictly controls expenditure. Without ongoing budgeting and review there is a real risk of 'gold plating', which in the long run will result in unnecessarily higher prices to the detriment of end-users.

4.5 Higher prices will be the inevitable result if costs which are greater than the prudent and necessary level are included in the RAB. The first ten years are a critical period, in which NBN Co should be subject to very detailed scrutiny, since a substantial proportion of the RAB will be determined during this time. It is therefore of utmost importance to ensure upfront spending is intensively analysed. The ACCC should therefore have a much greater role in overseeing costs as they are incurred, than the light-handed approach currently proposed.

4.6 NBN Co should be required to provide forecasts of capital expenditure at regular intervals (eg, every 3 years) in the build phase. Since construction is intended to be modular, the ACCC could undertake forecasts and review in respect of each module. Oversight can then be provided both in terms of reviewing forecasts and reviewing building works that have been completed, ie, subsequently checking actual expenditure against forecast. This approach will also provide opportunities for 'learnings' by both NBN Co and the ACCC regarding improvements that can be made to their respective processes.

4.7 Optus considers that the regulatory endorsement process should heavily involve the ACCC - not fetter its rights to protect the end-users of monopoly infrastructure. It is just not reasonable to do otherwise. The involvement of the ACCC in the points of interconnect (POI) decision exemplifies the important role that the ACCC can play in ensuring pro-competitive network design involving many more POIs. Without ACCC oversight of the POI decision NBN Co would have made a very different design decision. This would have resulted in a number of outcomes which would be contrary to the long term interests of end-users, as Optus has submitted to the ACCC, since the decision would have: [18]

(a) Foreclosed opportunities for the development of competitive wholesale markets in the provision of high-speed voice and broadband services;

(b) Undermined the opportunities to promote regional development by concentrating interconnect arrangements on the capital cities;

(c) Foreclosed opportunities to exploit and develop existing competitive backhaul capacity;

(d) Resulted in overbuild and the stranding of significant levels of competitive infrastructure;

(e) Raised significant claims for compensation, likely to run into hundreds of millions of dollars, in respect of that infrastructure;

(f) Heightened sovereign risk associated with infrastructure investment in Australia; and

(g) Lead to the consolidation of current interconnection arrangements at the NBN POI's that will likely see NBN Co becoming the default carrier of all data and voice traffic between retail service providers.

4.8 By contrast, the ACCC's semi-distributed approach to the POI issue:[19]

(a) is likely to best promote retail and wholesale competition across all geographic markets;

(b) would be likely to result in optimal outcomes for competition in transmission markets; and

(c) is likely to have other potential benefits, namely reducing the extent of asset stranding.

4.9 It is therefore clearly appropriate for the ACCC to be involved in network design decision making in order to ensure that it results in the best possible outcome for competition, and in turn, end-users.

Changes to network design rules

4.10 Following the initial approval of the network design rules, any variations to account for new products or services will be subject to a different approval process. Optus supports the proposal for a customer engagement process in order that those that will be paying for the change are able to review and influence it.

4.11 However, in order for the customer engagement process to be worthwhile, NBN Co should not be able to bypass the process. Given they constitute the customer base for any new product or service, access seekers should have input into the design in all cases. Therefore, the customer

[18] Optus, *Optus Submission: National Broadband Network Points of Interconnection,* November 2010, pp3-4

[19] ACCC, *ACCC Advice to Government: National Broadband Network Points of Interconnect*, November 2000, pp.2-3

engagement process should be a mandatory 'first port of call' – not a voluntary complement to regulatory approval.

4.12 The customer engagement process would be further strengthened if NBN Co was only able to have a proposal approved by the regulator if it had already secured a minimum, pre-determined, level of support from the customers (eg 60%-70%). Only in the event that there is overwhelming support for a change from customers (eg 90%), NBN Co should be able to bypass regulatory approval, as those that will be paying for the change would have shown their willingness to support it.

4.13 In order to canvass approval from the customer engagement process NBN Co has proposed to prepare a 'prudency implementation paper'. Optus strongly supports the principle for transparent information exchange for the endorsement process. It does however have a concern that the paper would seek endorsement on the basis of 'net economic benefits' as opposed to the legislative criteria of the 'long term interests of end-users' (LTIE). Optus believes that the LTIE criteria should continue to be utilised in telecommunications regulatory decision making, on the basis that these criteria are well understood and have stood the test of time.

Prudent cost condition

4.14 The proposed prudent cost condition is essentially a criterion for NBN Co to meet competitive tendering requirements. It is an appropriate approach to ensure that NBN Co endeavours to undertake a 'best practice' approach to its procurement.

4.15 However, the prudent cost condition simply relies on NBN Co following a standard, formalised tendering process. This alone is not sufficient to ensure that the costs which NBN Co incurs are prudent, efficient and in line with the LTIE. An item of expenditure may have been procured in accordance with a formal tendering process and nevertheless contain inflated costs. Moreover, a standard tendering process requires the exercise of a significant degree of judgement and discretion and so is necessarily subjective.

4.16 It is therefore critical that the ACCC (and industry) have ongoing review of NBN Co's costs and governance to ensure that they are appropriate and consistent with the LTIE. Formal review of costs incurred by the ACCC would also offer the opportunity to benchmark NBN Co's contract costs and subject them to public scrutiny to prevent potential contractors from taking advantage of NBN Co.

Ongoing operating and capital expenditure forecasts

4.17 It is unacceptable that the first ten years of operating and capital expenditure are not subject to ACCC review and public consultation. As discussed above, there is significant scope for the ACCC to do 'stock take' reviews at designated rollout points and assess the outcomes against the business plan or other benchmarks, such as indicative contract costs.

4.18 The requirement to participate in a public consultation and report to the regulator will provide NBN Co with the opportunity to revise its processes and implement cost reductions for subsequent phases.

Section 5. Non-Price Commitments

5.1 NBN Co has proposed to include a number of non-price commitments in its SAU. Optus' responses to the proposed SAU commitments are set out in later in this section. Before turning to the specific commitments, however, we set out our views on the inter-relationship between the SAU and the Wholesale Broadband Agreement.

The SAU and the Wholesale Broadband Agreement

5.2 NBN Co has described the relationship between the SAU and the Wholesale Broadband Agreement (WBA) in its discussion paper, noting that they are intended to operate as complementary documents.[20] While the WBA is intended to provide parties with the flexibility to make changes to the terms, the SAU will provide parties with regulatory certainty since the ACCC will assess the terms outlined in the SAU against the "reasonableness" criteria set out in Part XIC of the CCA. NBN Co has stated that it will commit in the WBA that it will not exercise rights under the WBA in a manner that is inconsistent with the operation of the SAU.[21]

5.3 Optus has concerns about how the relationship between the SAU and the WBA will operate in practice. In particular, it is not clear how access seekers can have any confidence that the WBA will be consistent with the SAU. Nor is it clear how access seekers can have any confidence that the extensive non-price terms in the WBA are reasonable and in accordance with the LTIE, given that there is no provision for the ACCC to review the terms of the WBA.

5.4 The solution to these issues is that the ACCC should review the WBA as an integral part of its review of the SAU. Indeed, given that the SAU contains the long term high level commitments intended to govern access seekers' relationship with NBN Co, if any terms in the WBA are <u>not</u> reasonable and consistent with the LTIE, then this deficiency in the WBA is clearly indicative of a deficiency in the SAU. It follows that in order to properly review the SAU (and particularly its non-price terms) the ACCC must also review the WBA.

NBN Co SAU Non-Price Commitments

5.1 NBN Co has proposed to include in its SAU a number of non-price commitments. They include:

- (a) Product Development and Withdrawal;
- (b) NBN Rollout and Upgrade Consultation and Notification Process;
- (c) Review of POI locations;
- (d) General Non-Price Terms and Conditions
  - (i) Access to NBN Co's IT platforms and information about those platforms;
  - (ii) Confidentiality commitments;
  - (iii) Credit Management;
  - (iv) Contract Lifecycle Management;

[20] NBN Co, "*NBN Co Discussion Paper Introducing NBN Co's Special Access Undertaking July 2011",* pp.3-4

[21] NBN Co, "*NBN Co Discussion Paper Introducing NBN Co's Special Access Undertaking July 2011",* p.5

(e) Dispute Management Rules; and

(f) Reporting Commitments.[22]

5.2 Optus supports NBN Co's proposal to include non-price commitments in the SAU.

5.3 In addition to the key non-price commitments NBN Co has identified, Optus considers NBN Co should further include other non-price commitments outlined in the WBA in the SAU. Some of the additional non-price commitments NBN Co should include in the SAU are:

(a) Service levels commitment

Optus considers NBN Co should provide service levels commitment to its customers. This in particular applies to NBN Co's product which underpins a service to which a Customer Service Guarantee applies.

(b) Billing terms

To promote regulatory certainty, NBN Co should make long term commitments about the billing arrangement, billing disputes and the process. Optus does not consider billing terms are likely to vary considerably year on year.

(c) Liability and risk management

NBN Co should outline in the SAU the allocation of responsibilities between NBN and Customers. The inclusion of this provision will provide parties the regulatory protection considering the ACCC will assess the terms against the "reasonableness" criteria under Part XIC of the CCA. This will also ensure the terms are fair and reasonable.

(d) Changes to the operational manual

The process for changing the operational manual should be outlined in the SAU as it promotes regulatory certainty and regulatory protection. For example, NBN Co should not be allowed to make unreasonable changes to the operational manual unilaterally. Again, this ensures the terms are fair and reasonable.

5.4 Optus' detailed comments in response to the non-price commitments NBN Co has identified in the SAU are outlined below.

Product Development and Withdrawal

5.5 NBN Co states that over the course of its undertaking period, new products will be introduced and existing products may be modified and/or withdrawn. NBN further states that the SAU defines certain Product Development and Withdrawal processes, and the circumstances in which they apply, commits to publishing a Product Roadmap and describes the operation of the Product Development Forum (PDF). NBN Co however states that the PDF Processes do not form part of the SAU.[23]

5.6 Optus supports NBN Co's proposal to include this commitment in the SAU as it provides certainty to customers about the Product Development and Withdrawal processes. This is

[22] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011, pp.46-48

[23] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011,p.46

important as changes to NBN Co's product could bring significant consequence to customers and hence end users. Customers should therefore be consulted before the products are developed, modified and/or withdrawn.

5.7 It is however unclear why the PDF Processes do not form part of the SAU. This is particularly so when the PDF Processes actually define the product development model between NBN Co and its customers and the criteria NBN Co used in assessing product ideas.

5.8 The Product Development and Withdrawal processes and the PDF Processes are interrelated to one another. The inclusion of the PDF Processes in the SAU will therefore promote consistency between the WBA and SAU and will provide regulatory certainty to NBN Co's customers.

NBN Rollout and Upgrade Consultation and Notification Process

5.9 Optus supports NBN Co's proposal to make commitments in relation to NBN network rollout progress and NBN Major NBN upgrades in the SAU.[24] It is important customers are provided with sufficient notice about the rollout and the upgrade so that they could plan and take appropriate action accordingly.

Definition of "Major NBN upgrades"

5.10 NBN Co states that this provision is intended to only cover upgrades that "require customers to take particular action to continue to be able to use certain products or which require customers to commit to material expenditure in response to the implementation of that major NBN upgrade."[25]

5.11 This implies that NBN Co will only consult customers when it determines that an upgrade will, or will be likely to have a material adverse impact on the customer. This is not reasonable considering NBN Co will not be in a position to judge whether customers will be adversely impacted by the upgrade. Optus therefore considers NBN Co should define "Major NBN upgrades" broadly.

5.12 Any upgrade (apart from Emergency upgrades) that are not captured under "Major NBN upgrades" are considered "Minor NBN upgrades" under the WBA. It appears from the discussion paper that "Minor NBN upgrades" will not be included in the SAU.

5.13 Under the WBA the notice period between "Major NBN upgrades" and "Minor NBN upgrades" differ significantly considering "Major NBN upgrades" are provided with 6 months notice while "Minor NBN upgrades" are provided with only 1 month notice. Further, NBN Co does not have to consult with customers in the event of a "Minor NBN upgrade".

5.14 Optus therefore considers NBN Co should have a consultation with its customers when determining whether the upgrade is "Major" or "Minor". Otherwise customers could be adversely affected if NBN Co misjudges the impact of the upgrade on the customers.

Notice period

5.15 NBN Co has stated in the discussion paper that it will include in the SAU a minimum notice period of 6 months.[26] The 6-month notice period NBN Co has given for "Major NBN upgrades" is

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[24] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011,p.46

[25] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011, p.46

[26] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011, p.46

extremely aggressive for an event of this impact. Considering customers of NBN have a capital budget for each financial year and cannot necessarily budget for an unknown material capital expenditure, NBN Co should state in the SAU that it will limit Major NBN upgrades to two per year and provide customers with a minimum 12 months notice.

Review of POI Locations

5.16 NBN Co states that it will commit to review the number of POI and POI locations at least every 5 years.[27] NBN Co further states that it may choose to close or relocate POI locations but only in a manner consistent with the POI review conducted in accordance with the criteria agreed with the ACCC and on providing 12-month notice.[28] NBN Co further states that it may open new POIs at any time at its discretion and will provide a minimum 6-month notice.[29]

5.17 While NBN Co states that the ACCC will set criteria prior to NBN Co consultation with customers, Optus considers any decision to close or relocate the POI should only be done with the ACCC's approval.

5.18 The ACCC will be able to assess whether relocating a POI will result in significant loss to customers who have built infrastructure to the existing POIs. NBN Co will not be in a position to assess the true impact on the access seekers.

5.19 Similarly, any decision to open new POIs should also be subject to the ACCC's consultation and approval.

General Non-Price Terms and Conditions

5.20 Optus supports the NBN Co's proposal to include the following non-price terms and conditions in the SAU:

(e) Access to its IT platforms and information about those platforms;

(f) Confidentiality commitments;

(g) Credit management; and

(h) Contract Lifecycle management.[30]

5.21 NBN Co however has only provided a very brief description on each of these non-price terms and conditions. Optus therefore reserves its right to comment on these terms and conditions.

Dispute Management Rules

5.22 It appears from the discussion paper that only the key requirements of the dispute resolution process would be included in the SAU while the detailed dispute resolution terms and conditions are set out in the WBA.[31]

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[27] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011, p.47

[28] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011, p.47

[29] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011, p.47

[30] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011, p.47

[31] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011, p.47

5.23 Optus considers that both the key principles and the detailed dispute resolution terms and conditions should be included in the SAU.

5.24 The key principles and the detailed dispute resolution terms would be interrelated to one another. The inclusion of both the key principles and detailed dispute resolution terms and conditions in the SAU will promote consistency between the WBA and SAU and will provide regulatory certainty to NBN Co's customers.

Reporting Commitments

5.25 Optus supports the NBN Co's proposal to provide the ACCC with sufficient information to allow it to determine if NBN Co is meeting its commitments made in the SAU.[32] This will promote transparency and is consistent with the principle of non-discrimination between access seekers.

5.26 Optus further supports that the ACCC will be conferred powers to require NBN Co to provide reporting information as it ensures the information remains relevant over the term of the SAU.[33]

[32] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011, p.48

[33] NBN Co, *NBN Co Discussion Paper: Introducing NBN Co's Special Access Undertaking,* July 2011, p.48