Submission to the ACCC in relation to the revised Special Access Undertaking filed by NBN Co

This submission refers to the revised Special Access Undertaking filed by NBN Co with the Australian Competition and Consumer Commission (ACCC). That revised SAU was filed on 28 September 2012, along with considerable supporting material. However, the arguments advanced in that material have a number of deficiencies; some of these are discussed below.

Loss making entities do not have incentives to act efficiently

NBN Co contends, without providing any evidence, that loss-making government-owned entities (GOEs) have incentives to minimize their losses and hence act efficiently. On that basis, it asserts that prudency tests of its costs are not required.

There is nothing in theory or practice which supports that contention. In fact, the opposite is more likely to be the case. Loss-making GOEs are heavily dependent on government subsidies, which may be provided directly (i.e. as explicit or implied financial transfers) or through preferential regulation (for example, in the form of protection from competition). As a result, those entities have especially strong incentives to implement policies which yield political rewards to government, while shifting costs on to current and future consumers. Moreover, the larger their losses, the greater the incentive to divert investment into these forms of rent-seeking, as that strengthens their political mandate and helps protect the entity from painful cost reduction requirements.

That pattern is strongly evident in Australian experience. Far from exercising tight control over their costs, heavily loss-making entities have often acted to increase their losses (for instance, by reducing charges in loss-making product lines or in politically important areas) so long as the resulting gain in political support outweighed any added opprobrium from the increased deficit. ANL, AUSSAT, the government railways and public transport operators are all cases in point.[1]

The Commission should therefore reject NBN Co's claims that it faces effective incentives to ensure its costs are efficient and that prudency tests are not required to protect consumers.

[1] Indeed, this pattern is so long-established that it figured prominently both in Hancock's *Australia* and in Eggleston's *State Socialism in Victoria*. It was then confirmed by the Rae Report on GBE finances (1983) and by Zeitsch, J., R. Thomson, S. James, D. Evans and H. Reynolds (1990), *Measuring the Performance of Selected Government Business Enterprises*, Industry Commission Information Paper, Canberra. There is no evidence of any long term change in this pattern, as recent surveys of state public transport systems and water utilities attest. Moreover, the Commonwealth's own repeated difficulties managing ASC highlight the difficult principal-agent problems inherent in government ownership and operation of technologically sophisticated entities.

Cross-subsidies should be financed directly by government

Since the beginning of the microeconomic reform process in 1987, it has been a core principle that cross-subsidies should be avoided to the greatest extent possible, and where they cannot be avoided, should be fully transparent.

While the government has set out the objective of national price uniformity for NBN Co, there is nothing in the Competition and Consumer Act which requires the Commission to assume that objective is consistent with the long term interests of end-users. However, even were the Commission to accept that objective, there is no reason the government's pursuit of uniform pricing should be financed through a tax on NBN Co's consumers.

In effect, such a tax is an extremely inefficient way of financing subsidies to consumers in high cost areas and hence is inconsistent with the long term interests of end-users. As telecommunications is an intermediate input, imposing such a tax will not only lead to conventional allocative inefficiencies but will also result in a first-order productive inefficiency.[2] Rather, the welfare losses from pursuing uniform pricing are likely to be materially smaller were any resulting losses financed from consolidated revenue. (As a rough guide, the average excess burden of a cross-subsidy is likely to be in the order of 2 or more, while that of financing losses in high cost areas from consolidated revenue would be in the order of 0.3).

As a result, the Commission should disallow NBN Co from recouping any subsidies to high cost areas from its overall allowed revenues. Instead, NBN Co should be required to set prices in low cost areas at levels that reflect costs in those areas. If it chooses to set prices in high cost areas at levels that match those in low cost areas, the consequent losses should be recouped through a charge on government. Such a charge would obviously be reflected in the government's budget process and hence would be subject to the disciplines, transparency and public accountability that process involves.

Exactly the same principle applies when government mandates a higher standard of service than would be chosen by consumers. Again, there is nothing in the regulatory arrangements that requires the Commission to accept an arbitrary service standard. Moreover, even if it accepts that service standard, the associated costs should not be financed through opaque cross-subsidies.

Rather, as a general matter, the avoidance of cross-subsidies requires that no consumer or group of consumers pays charges that exceed the stand-alone costs they would bear were they free to opt-out.[3] Applied in an inter-temporal context, this principle implies that current consumers, treated as a coalition of the whole, should not be required to pay for making greater network capabilities available

2 For instance, it will distort input choices as between wireless and wireline technologies. Moreover, as a significant share of NBN Co's recoupment of non-traffic sensitive costs is intended to occur through usage-related charges for CVC and port access, it will distort usage decisions on the wireline network.

3 Additionally, charges to each consumer or group of consumers should at least cover efficient incremental costs.

than those consumers would themselves demand.[4] Moreover, future consumers should not be required to pay the holding costs of making greater network capabilities available sooner than would have been efficient.[5] Rather, to the extent to which government believes, as a matter of political decision, that it wants to make those capabilities available sooner than would prevail under the optimal expansion path, it should bear the full incremental cost that involves. As well as avoiding distorting cross-subsidies, that will ensure transparency of, and accountability for, the government's decision, which must promote the long term interest of end-users.

As a result, NBN Co should be required to report its costs on an efficient basis, i.e. in terms of the least cost required to provide services to each broad type of consumer and to each time period, and to charge no more than those costs to any material group of users.[6] Before NBN Co's SAU is accepted, there should be an agreed model for so doing. Obviously, such a model would be far from perfect, but it is still likely to be materially better than simply accepting NBN Co's decisions, all the more given the incentives, noted above, for NBN Co to maximize political support rather than consumer benefit.

Claimed externalities should be financed by government, rather than by distorting charges to consumers

Finally, it has been asserted that deployment of the NBN will yield wider benefits in the form of externalities. While those assertions are often extremely confused (not least as to what is meant by an externality), there are, for example, frequent claims that the NBN will allow significant cost reductions in areas such as health care and education.

To the extent to which there are such benefits, the full incremental costs associated with making them available should be charged to the entities that will enjoy the claimed savings. This is crucial to ensure that those entities in fact value these benefits at more than their cost – in more technical terms, charging them for those costs 'internalises' the effect and hence allows it to be market tested. The risk is that otherwise, apparent cost savings in one area (say, health care) will be achieved by imposing even greater costs elsewhere (say, on business users of broadband services).[7]

In practice, recoupment of these costs may best be achieved by mandating that they be recovered directly from the Commonwealth. For reasons noted above, this likely imposes a significantly lower excess burden than seeking their recoupment by distorting prices to all end-users. Moreover, it is consistent with

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4 An approach to determining the efficient rate of service capacity augmentation is set out in Henry Ergas and Alex Robson, *The Social Losses from Inefficient Infrastructure Projects: Recent Australian Experience*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1465226

5 In other words, holding losses associated with a politically mandated decision to build inefficiently ahead of demand should be excluded from the asset base.

6 As noted above, it could charge less than those costs (for instance, to consumers in regional areas) but the resulting losses should be financed through explicit Commonwealth transfers.

7 Equivalently, it is important to ensure that building the NBN is the least cost way of achieving the claimed benefit. Unless the benefiting entities are appropriately charged for securing those benefits through the NBN, there can be no assurance that that test will be met.

practice in the many areas where infrastructure providers are subsidized to cover the costs of external benefits – for example, public transport.[8] As a result, the 'externalities' NBN Co and the government have referred to should be quantified and the costs of securing them excluded from the allowed asset base.

Henry Ergas, October 10, 2012.

[8] In the case of public transport, the subsidies are intended to cover the external benefits public transport is claimed to provide in reducing congestion costs on the roads. Equally, higher education is subsidized in line with the external benefits it is claimed to provide, as reflected in the difference between private and social rates of return on higher education.