

Incentive Based Modular SAU: Design Principles

20 June 2012

Purpose

This document describes the revised approach that NBN Co is proposing for its SAU following feedback obtained from the ACCC and industry stakeholders. It is designed to provide interested parties with an early indication of how NBN Co is planning to address the issues raised by access seekers and the ACCC, but does not necessarily represent NBN Co's final position.

Background

NBN Co lodged its Special Access Undertaking (SAU) with the ACCC on 5 December 2011. On 20 December, the ACCC commenced formal consultation on the SAU as part of its assessment process. This has included two rounds of written submissions, and an industry forum on the SAU hosted by the ACCC. This consultation has identified a number of concerns held by industry in relation to the SAU that was lodged in December.

While the current SAU attempted to strike a reasonable balance between the needs of NBN Co, access seekers and end-users, the ACCC has indicated that the SAU is unlikely to be acceptable in its current form. This reflects a number of access seeker concerns relating in particular to the nature and extent of ACCC oversight over the 30 year term of the SAU, and level of certainty provided to access seekers as compared to the level of flexibility provided to NBN Co.

NBN Co acknowledges the legitimacy of these concerns, and has developed its revised approach accordingly.

Summary of Incentive Based Modular SAU approach

- The incentive based modular SAU provides a 30 year regulatory framework that strikes a balance between the long-term interests of end-users, access seekers and NBN Co, including uniform national wholesale pricing, pricing stability and predictability, economic efficiency and the opportunity for cost recovery. Different modules of the SAU will apply in different time periods, with different levels of detail provided in each module.
- The modules that are currently envisaged for the SAU include:
 - **Module 0:** Contains the foundational terms of the SAU that would apply for 30 years, including the term of the SAU, service description and necessary legal “boilerplate” terms.
 - **Module 1:** Contains a set of detailed terms that will expire after 10 years¹, covering matters such as reference offers, price controls, product development, regulatory recourse, prudence, non-price terms and conditions, and the operation of the long term revenue constraint mechanism.
 - **Module 2:** Contains long-term arrangements that apply from year 11 to year 30, particularly covering matters to do with long term cost recovery and pricing. Some of these terms will be described in a quite detailed manner; others will be described at a higher level.
 - **Module 3:** Contains a detailed set of terms that would apply in conjunction with Module 2 after the expiry of Module 1. Prior to the expiry of Module 1, NBN Co intends to submit a SAU variation² to the ACCC, setting out the detailed terms to apply, which would then be assessed by the ACCC for their reasonableness. This process would repeat every 3-5 years.

¹ “10 years” is an indicative time period. The actual period specified will reflect the anticipated completion of the network deployment and migration of end-users from the copper network.

² Under section 152CBG of the *Competition and Consumer Act 2010* (CCA)

- Modules 0, 1 and 2 would be included in the initial SAU that is lodged with the ACCC. Modules 3 and onwards would only be included should subsequent variations be accepted by the ACCC. The intended operation of the incentive based modular SAU approach over 30 years is as shown below:

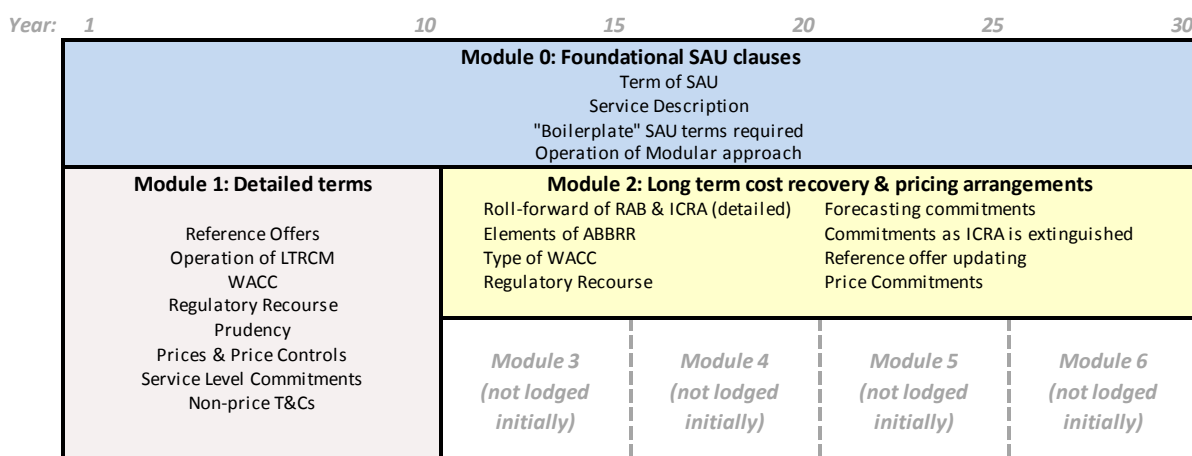


Figure 1: Overview of key elements of the incentive based modular SAU approach

- The ACCC not accept the variation that implements Module 3 (or subsequent modules), the commitments in Module 2 would continue to operate, and the ACCC would have the ability to establish access terms via access determinations (ADs) or binding rules of conduct (BROCs), which would apply to the extent that they are not inconsistent with Module 0 or Module 2.
- NBN Co would therefore always have strong incentives to ensure that it renewed the detailed terms in a way that appropriately addressed the prevailing needs of the industry at the relevant time.
- In addition to its modularity, the revised SAU approach provides a greater role for incentive mechanisms than the original SAU. These mechanisms are intended to operate together so that over the 30 years of the SAU it is commercially rational for NBN Co to make prudent and efficient expenditure decisions (subject to meeting service level commitments) and to make economically efficient pricing decisions (subject to meeting a range of short term and long term price commitments).
- Consistent with these incentives, NBN Co will have discretion to set initial prices for new products and ongoing prices for existing products (with no conferral of powers on the ACCC to determine such prices), subject to compliance with SAU commitments.
- In Module 1, the currently proposed approach to prudence of expenditure, allowing actual costs to be included in the cost base, subject to compliance with SAU commitments, will be used. The Module 2 commitments then revert to a more traditional 'incentive-based' forecasting mechanism.
- Module 1 will contain a package of commitments which together ensure that access seekers have regulatory recourse to ACCC decisions when they cannot reach agreement with NBN Co on access terms. The SAU will include commitments to the effect that:
 - A 2 year term standard form of access agreement (SFAA) will always be made available;
 - ACCC decisions (ADs and BROCs) will be flowed through to the SFAA (where they are not inconsistent with the terms of the SAU), with the SAU defining the processes by which NBN Co will implement the changes to the term of the SFAA.
 - These decisions will then be available to all access seekers including those on access agreements, who will be able to take up the new terms at the expiry of their access agreement (i.e. after at most 2 years)
 - Multilateral processes will be established to provide an ongoing forum for access seekers to request changes to the SFAA (similar to the current Contract Development Process).

- Explicit commitments will be made in the SAU that the terms and conditions of the SFAA will be consistent with the SAU (including timeframes for alignment of the SFAA).
- The SAU will include “reference offers” with commitments to supply them over the term of the active Module in which they are defined.
- The service description will be expanded to cover all services required to receive supply of the NBN Access Service, including ancillary services.
- Initial prices will be specified in the SAU for all services with known prices at the time of lodgement.
- Non-price terms will be specified in Module 1 at a level of detail consistent with that in the SFAA, with the SAU remaining entirely silent on other non-price terms.
- Enhanced compliance powers will be conferred on the ACCC to ensure that NBN Co is compliant with the commitments made in the SAU in relation to prudence, operation of cost recovery etc.

Detailed description of the proposed SAU approach

This section describes two of the key elements of the incentive based modular SAU approach: (1) the operation of the different modules over 30 years, and (2) the proposed regulatory recourse arrangements that address the interaction between the SAU and SFAA.

1) Modular operation of the SAU

Initial SAU that is lodged

A fundamental difference between the proposed Modular SAU and the SAU lodged on 5 December 2011 is that only a subset of the terms and conditions (focussed on key cost recovery, pricing and product development aspects) will (in effect) apply for the full 30 year term of the SAU. The detailed terms that provide the initial specific implementation of the SAU will only apply for a period of approximately 10 years. Once that period expires, those initial terms will lapse, and in order to regain regulatory certainty, NBN Co would need to submit a SAU variation (in the form of a “Module 3” etc) specifying a new set of detailed terms that would work in combination with the continuing long term provisions to implement an updated set of detailed SAU terms that would apply for a defined period (e.g. from 3 to 5 years). This cycle would be repeated until the 30 year term of the SAU expires.

This approach will provide the ACCC with the opportunity to periodically assess a proposed set of detailed operating terms under the standard provisions in Part XIC, and reject them if not satisfied that the terms are reasonable. Should this occur, the ACCC would have the opportunity to establish detailed access terms through ADs or BROCs – which would apply to the extent that they are not inconsistent with the long term provisions of the SAU already accepted by the ACCC.

When lodged, the SAU will have the following modules defined:

Module 0: This covers the foundational elements required to operate the SAU over 30 years. This module would include:

- A broad functional service description setting out the service to be declared for the term of the SAU. This would be an end-to-end service on NBN Co’s network including ancillary services required to receive supply.
- Commitment to comply with Category B SAOs.
- Commitments that any non-price terms and conditions in an accepted SAU will be included in an SFAA and commitment that the SFAA will be consistent with the terms of an accepted SAU.
- All “boilerplate” terms and conditions necessary to legally establish the SAU (e.g. setting out an expiry date for the SAU).

Module 1: This specifies the detailed terms and conditions that would apply for the first “10 years” of the SAU. This would be at a similar level of detail to that included in the current SAU, and would explicitly cover elements such as:

- Detailed terms and conditions in relation to the supply of the NBN Access Service. For example, in order to receive supply of the NBN Access Service, an access seeker will need to acquire all four product components (AVC, CVC, UNI and NNI), and NBN Co will make a commitment not to withdraw these initial product components for the duration of Module 1.
- Definition of reference offers and commitments in relation to them. This will include specifying a number of AVC speed tiers, CVC and NNI, and ancillary services required to deliver an end-to-end service to end-users. The reference offers will not be varied or withdrawn during the term of Module 1.
- Operation of regulatory recourse (described further in next section).
- Prudency arrangements (similar to those in current SAU, but with enhanced compliance reporting as described below).
- Price commitments (in relation to both reference offers and non-reference offers) that will result in real price decreases.
- Initial prices for all products and ancillary services definitively known at the time of lodgement of the SAU, including ancillary charges associated with them.
- Confirmation of NBN Co's intention to reduce CVC pricing over time, subject to the achievement of aggregate demand metrics (as indicated in the Corporate Plan).
- Commitments in relation to service levels.
- Product development and withdrawal, including the Product Development Forum. In response to industry feedback, NBN Co will also be revising the arrangements relating to the management of intellectual property and confidential information in respect of product development (further details will be provided in the current Contract Development Process).
- Detailed formulae used to define the operation of the long term revenue constraint, including roll-forward of RAB and ICRA, WACC, ABBRR, depreciation and taxation³.
- Non-price terms and conditions. Dispute management rules will also be included in the SAU.
- Enhanced compliance and reporting – specific reporting commitments to ensure transparent oversight of NBN Co's compliance with the SAU. In particular, these commitments will cover such areas as prudency of expenditure, operation of the LTRCM and annual price increase limits.
- Reviews – for example of the operation of the PDF, customer engagement, procurement rules, non-price terms and conditions, service levels, the operation of the regulatory recourse arrangements and the reporting and compliance arrangements. These reviews would take place after 5 years.

The terms and conditions of Module 1 would explicitly expire at the end of its “10 year” term. In the lead up to that time, in order to seek continuing regulatory certainty, NBN Co would lodge a set of detailed arrangements for the ACCC's consideration as a variation to the SAU (see Module 3 below). If the variation is not accepted, the door would be open for the ACCC to determine detailed arrangements itself (e.g. via access determinations) – and these would apply to the extent that they were not inconsistent with the terms of Modules 0 and 2 already accepted by the ACCC.

³ See NBN Co's SAU lodged on 5 December 2011 for details of what these terms cover.

Module 2: This would apply from “year 11” onwards (i.e. after the expiry of Module 1). It would contain the key long term arrangements that would apply until year 30. The elements covered by Module 2 would in some cases be defined in a fully specific and quite detailed form, and in other cases be defined in a less detailed, more “principled” form. The intent behind Module 2 is that it would provide certainty about the key elements required to provide NBN Co with the opportunity for long-term cost recovery, while also providing certainty to industry through NBN Co making key long-term commitments related to how it will price its services. Module 2 covers such matters as:

- The roll-forward of the RAB and ICRA (at a detailed level).
- The nature of WACC (e.g. that it is a nominal vanilla WACC, but not its level).
- The elements to be included in the Annual Building Block Revenue Requirement (ABBRR), but not the detailed specification of those elements. The module is likely to include some principles around these elements, but not the detailed formulae that would appear in Module 1.
- ABBRR to be determined on an ex ante basis for 3 to 5 year periods with forecast capex and opex.
- Process commitments related to capex and opex forecasting.
- Commitments in relation to NBN Co’s behaviour as the ICRA is extinguished.
- Commitments in relation to revision of reference offers – the revised reference offers will apply for the same period as that for which the ABBRR is forecast.
- Price commitments, across reference and non-reference offers, including:
 - an individual price increase limit that would result in real price decreases over time; and
 - a weighted average price cap, which would be updated every 3 to 5 years in line with the periods used for the revised reference offers and the ABBRR forecasts, cover essentially all of NBN Co prices, and be based on forecasts of revenue and demand.
- Commitments in relation to the terms and conditions on which the declared service will be supplied as well as commitments regarding product development and withdrawal.
- Statement of intention in relation to regulatory recourse over the longer term.

Operation of the SAU after expiry of Module 1

As noted above, prior to the expiry of Module 1, NBN Co intends lodging a variation to the SAU (under section 152CBG of the CCA) to introduce a new set of detailed terms that would operate in combination with those terms in Modules 0 and Module 2, when Module 1 ceases to operate on its expiry. This variation would likely need to be lodged 9-12 months prior to the expiry of Module 1, to ensure the ACCC’s assessment process can be completed in time (and this may potentially involve NBN Co having to resubmit based on ACCC feedback). This variation would introduce a “Module 3”, which would contain detailed terms and conditions that would operate for the next 3 to 5 years. This same process would apply in subsequent periods.

It is intended that the ACCC would assess this variation request in accordance with s.152CBG, and accept or reject the variation posed by Module 3. This assessment would consider the context of the entire varied SAU (i.e. by considering the terms of Modules 0, 2 and 3). Should Module 3 be rejected, Modules 0 and 2 would continue to operate, but these would not provide the same granular specificity on the terms and conditions of access as Module 3. The NBN Access Service and Ancillary Services would continue to be declared and supplied under the SAU and NBN Co would still have commitments to comply with under Modules 0 and 2 of the SAU.

As Module 2 will contain some detailed terms in relation to the roll-forward of the RAB and the ICRA, it is not necessary for Module 3 (and subsequent modules) to contain all terms related to the operation of the LTRCM. Instead, it is NBN Co's intention that Modules 0, 2 and 3 would operate together to provide the complete set of terms under which NBN Co will supply services. However, where Module 2 only describes high level principles associated with a particular aspect, it is intended that Module 3 would provide the detailed terms once accepted (for example, Module 2 would specify that the WACC used in the ABBRR calculation will be of the nominal vanilla form, while Module 3 would set out the specific value of the nominal vanilla WACC (or the method of ascertaining it) to use in that calculation for a given period of time).

2) Interaction of SAU & SFAA: Regulatory recourse mechanism

To ensure that the terms and conditions of the Standard Form Access Agreement (SFAA) reflect the SAU once accepted, a commitment will be made in the SAU that the SFAA will be consistent with an accepted SAU. Access Seekers will then be able to receive supply of the NBN Access Service and Ancillary Services (via an executed access agreement with NBN Co) on a basis consistent with the terms and conditions of the accepted SAU. This commitment would also ensure that as variations to the SAU are accepted (e.g. via Module 3) that the SFAA would be updated to align with the SAU at that point in time.

To facilitate NBN Co and access seekers reaching a set of mutually agreeable terms and conditions in the SFAA, NBN Co will commit to having a forum (similar to the current CDP) where access seekers and NBN Co are able to engage in discussion on changes to the terms of the SFAA. This will provide an open and multilateral forum to identify issues with the terms of the SFAA and develop possible resolutions, whilst meeting NBN Co's non-discrimination obligations. While the forum will always be available to access seekers to engage with NBN Co, they will always have the ability to request that the ACCC make an AD or BROCC on any terms of the SFAA. Accordingly, the SAU will acknowledge an access seeker's right to seek an AD or BROCC and the ability of the ACCC to issue an AD or BROCC.

The ability for access seekers to seek, and for the ACCC to make, an AD or BROCC provides NBN Co with an incentive to engage productively with access seekers to reach mutually agreeable terms and conditions. Further, the forum promotes commercial resolution between NBN Co and industry whilst assisting the ACCC to identify terms and conditions on which it may consider it necessary to intervene via the making of an AD or BROCC.

If the ACCC makes an AD or BROCC, the SAU will describe a mechanism to 'flow through' to the SFAA any terms made by the ACCC in an AD or a BROCC to the extent that these terms are not inconsistent with the SAU.

Broadly this mechanism will include the following commitments in the SAU:

- To update the SFAA to reflect any terms and conditions of an AD or BROCC to the extent that those terms are not inconsistent with the SAU
- To update the SFAA within a certain time once an AD or BROCC comes into force;
- To make necessary changes to the SFAA to update it following any changes arising from differences between an IAD and FAD; or a variation/withdrawal of the AD or BROCC.

NBN Co recognises that practical implementation of an AD/BROCC into an SFAA may involve a degree of interpretation by NBN Co. However, given that the ACCC would be able to make a subsequent AD, or more likely a BROCC specifying implementation, NBN Co will have an incentive to ensure its

practical implementation of the initial AD or BROC was acceptable to access seekers, and consistent with the intent of any ACCC decision.

Following the incorporation of the terms into the SFAA, all access seekers will be able to request supply on those terms. For those access seekers that have already executed an access agreement, the new terms of the SFAA will be available to them at the expiry of their current agreements. In acknowledging the ACCC's concern that NBN Co will expect access seekers to enter into long-term commercial agreements prior to regulated terms being established on matters that are contentious (i.e. prior to having access to regulatory recourse), NBN Co will commit in the SAU to offer a short term, (2 year), SFAA. This will ensure that all access seekers will have the ability to access any regulated terms a maximum of 24 months after they are made.

The combination of the recourse mechanism and the short term SFAA, whilst preserving the primacy of commercial negotiations and signed access agreements (See Figure 2 below), is intended to address the ACCC's concern that access seekers must have an opportunity for recourse to a regulated outcome in the absence of genuine agreement.

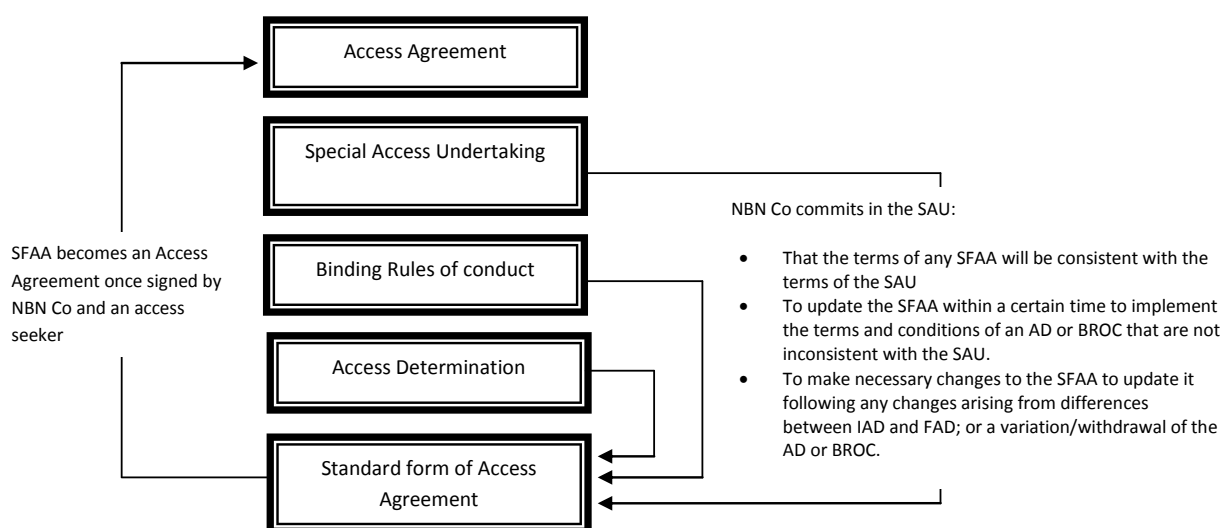


Figure 2: Intended operation of the regulatory recourse mechanism

Module 2 will contain a statement of intent in relation to ongoing regulatory recourse arrangements (i.e. after the expiry of Module 1). The precise details of the ongoing mechanism will be included in module 3 after evaluating the effectiveness of the operation of the mechanism in Module 1.

Next Steps

As NBN Co drafts the detailed operation of the approach outlined in this paper, we will continue to discuss the details of the approach with the ACCC and other stakeholders, with a view to identifying and resolving any issues with the revised approach. To provide certainty to industry, NBN Co is aiming to lodge a revised SAU with the ACCC well in advance of the completion of the current Contract Development Process in relation to the Wholesale Broadband Agreement (WBA), to maximise the prospects of having the SAU accepted before expiry of the current, short term WBA.