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Dear Stakeholder

**Re: NBN Co's LTRCM determination for 2015-16**

I am writing to inform you that the Australian Competition and Consumer Commission (ACCC) will soon be commencing its assessment of NBN Co's Long Term Revenue Constraint Methodology (LTRCM) determination for 2015-16.

In June 2016, we finalised the LTRCM determination process for 2014-15. As we have now completed the LTRCM determination process on two occasions, we believe it is an appropriate time to review the process and consider our assessment approach for this year.

This letter sets out the LTRCM requirements specified in NBN Co's Special Access Undertaking (SAU) and our proposed process and timeframes for preparing the determination for 2015-16. It also invites your comments on the process and NBN Co's regulatory information, once it becomes available in early November 2016.

***Overview of the LTRCM***

We are required to make annual determinations on NBN Co's revenue controls in accordance with the LTRCM framework set out in NBN Co's SAU. The LTRCM revenue controls provide NBN Co with the opportunity to recover its efficient long-term costs over the duration of the SAU (including a normal commercial return), and assurance to access seekers that NBN Co will be able to recover no more than this. The LTRCM framework also provides for assessment of NBN Co's expenditure against certain prudence criteria.

In addition to the revenue control provisions, the SAU includes a cap on the prices NBN Co is allowed to charge for its services. We also use the LTRCM process to report on NBN Co's compliance with these price controls.

The SAU sets out the LTRCM framework in some detail. An overview of the SAU requirements, including the criteria for assessing prudent expenditure and the regulatory information NBN Co is required to submit to the ACCC, is included at Attachment A to this letter.

***ACCC assessment process***

This is the third year that the ACCC will be undertaking the LTRCM assessment process. Given that the SAU sets out the matters the ACCC must consider in detail, much of the ACCC's process will be similar to previous years. However, we are also considering whether there are additional activities that should be undertaken to improve the assessment process.

We are inviting stakeholder comments on the LTRCM process to ensure that it is as transparent and useful as possible.

The process for each of the ACCC's previous LTRCM determinations consisted of the following:

- publishing NBN Co's public regulatory information on the ACCC website in November
- providing NBN Co with our preliminary views on capital and operating expenditure in December (and publishing it on the ACCC website)
- undertaking a formal consultation process at the draft decision stage, and
- making our final decision in June.

In making our decision, we are required to consider whether the expenditure proposed by NBN Co had been incurred in a prudent and efficient manner, and that the relevant LTRCM components had been calculated in accordance with formulas set out in the SAU

In the 2014-15 LTRCM determination, we assessed whether expenditure was prudent by considering whether:

- NBN Co had developed adequate procurement rules
- there were processes and controls in place to support compliance with the prudency conditions in the SAU, and
- these processes and controls were operating effectively.

Our assessment was informed by several factors. To assess whether NBN Co had adequate procurement rules we reviewed the documents that comprise NBN Co's procurement rules to check that they complied with the relevant SAU requirements and also considered NBN Co's procurement rules compliance report. To determine whether there were appropriate processes and controls in place, we relied on PwC's independent assurance report regarding the design of controls applicable to capital and operating expenditure. To examine whether the processes and controls were operating effectively, we relied on NBN Co's expenditure compliance report and additional information in NBN Co's supporting submission regarding its internal audit work.

We then examined whether NBN Co's proposed LTRCM values had been calculated in accordance with Schedule 1D and 1E of the SAU. Our assessment included reviewing the financial information provided by NBN Co and the assurance report provided by PwC. We checked the calculations NBN Co submitted in its LTRCM spreadsheet and confirmed the formulas used in the spreadsheet were as set out in Schedule 1E of the SAU.

We also assessed NBN Co's compliance with the price controls specified in the SAU. Our decision was informed by NBN Co's price compliance report, analysis of NBN Co's price compliance spreadsheet and PwC's limited assurance review of NBN Co's price controls.

We are currently considering additional ways to assess NBN Co's regulatory information for the purposes of preparing the LTRCM determination. These may include undertaking additional activities to further understand and examine NBN Co's procurement processes. We are interested in your views on how we could improve the LTRCM process and invite suggestions for any additional lines of inquiry the ACCC should pursue.

An indicative timeline for our 2015-16 process is set out below.

<b>Date</b>	<b>Event</b>
November 2016	Regulatory information available for comment
December 2016	ACCC preliminary view on capital and operating expenditure
March 2017	ACCC draft decision
April 2017	Consultation on draft decision
June 2017	ACCC final decision

### ***Confidentiality arrangements***

Similar to previous years, we expect that NBN Co will establish confidentiality arrangements for access to confidential material contained in its LTRCM proposal and supporting submissions. Parties wishing to access confidential material for the purposes of making a submission to the LTRCM determination inquiry should contact NBN Co directly to arrange an appropriate confidentiality agreement.

We will monitor the operation of NBN Co's confidentiality arrangements. We are keen to ensure that the arrangements achieve an appropriate balance between promoting transparency and protecting NBN Co's confidential information. We encourage stakeholders to advise us of any significant concerns regarding the implementation of these confidentiality arrangements. We will discuss with NBN Co any concerns raised by stakeholders about the operation of the confidentiality arrangements.

### ***Invitation to comment***

We invite comments from stakeholders on our proposed process and NBN Co's LTRCM submission to inform our consideration of the 2015-16 LTRCM determination. We anticipate that we will publish NBN Co's public submission and regulatory information on the ACCC website on or around 2 November 2016.<sup>1</sup>

In particular, we would be interested in your views on whether you consider there are ways we can improve our LTRCM assessment process or particular questions we should raise with NBN Co. Some questions you may wish to address are set out below.

#### **Questions for comment**

1. Is the ACCC's process for undertaking the LTRCM determination for 2015-16 sufficiently clear and transparent? If not, please provide your reasons and any suggestions for improvement.
2. Do you consider that you have adequate opportunity to comment at various stages of the LTRCM process?
3. Do you have any particular areas of concern with the process undertaken by the ACCC and NBN Co?
4. Do you consider that NBN Co's internal and external audit processes are sufficiently robust to provide confidence that NBN Co's expenditure has complied with the prudence

<sup>1</sup> See: <http://www.accc.gov.au/regulated-infrastructure/communications/national-broadband-network-nbn/nbn-co-special-access-undertaking>

conditions in the SAU? Please provide your reasons.

5. Should the ACCC undertake additional activities to assess NBN Co's expenditure compliance with the prudency conditions in the SAU? If so, please provide details.
6. Are there any questions the ACCC should raise with NBN Co to further examine NBN Co's procurement processes or regulatory information?
7. Do you have any comments on NBN Co's submission of regulatory information? If so, please provide details.
8. Have you sought access to NBN Co's confidential regulatory information? If so, have you encountered any issues with this process?

### ***Next steps***

In order to consider comments prior to issuing our preliminary view on capital and operating expenditure, we would appreciate your comments by 5:00pm 18 November 2016. We intend to publish all submissions on the ACCC website. Interested parties wishing to submit commercial-in-confidence material to the ACCC should submit both a public and a confidential version of their submission and ensure that all confidential information has been appropriately redacted in the public version.

Written responses should be emailed to [nbn@acc.gov.au](mailto:nbn@acc.gov.au). Alternatively, you can contact Scott Harding (Director, NBN and Pricing Coordination) on (03) 9658 6434 if you would like to discuss further.

Yours sincerely

Clare O'Reilly  
General Manager  
Mobiles, Transmission and Consumer

## LTRCM framework and SAU requirements

We are required to make annual determinations on NBN Co's revenue controls in accordance with the LTRCM, which is set out in NBN Co's SAU. The SAU is a long term undertaking that establishes the regulatory framework for the National Broadband Network (NBN). The SAU was accepted by the ACCC on 13 December 2013 and will expire on 30 June 2040.

During the first 10 years of the SAU, we are required to make annual LTRCM determinations specifying the amount of revenue NBN Co is allowed to earn each financial year based on expenditure that NBN Co has incurred. The purpose of the LTRCM is to provide NBN Co with the opportunity to recover its prudent and efficient costs of supply.

In making an LTRCM Determination, we must determine the following values based on regulatory information provided by NBN Co:

- Annual Building Block Revenue Requirement (ABBRR)—this is the amount of revenue NBN Co is allowed to earn in each financial year, and
- Regulatory Asset Base (RAB)—this is the net value of NBN Co's regulated assets.

The shortfall between allowed revenue (the ABBRR) and actual revenue during the rollout phase is accrued in the Initial Cost Recovery Account (ICRA) to be recovered in later financial years.

### *Prudent expenditure*

We must be satisfied that NBN Co has incurred its expenditure in accordance with the prudency conditions set out in the SAU and that the relevant LTRCM components have been calculated in accordance with formulas set out in the SAU. This will ensure that NBN Co will have the opportunity to recover its efficiently incurred costs over time, including an appropriate rate of return on investment, but no more than this amount.

In making the LTRCM determination, capital expenditure may only be included in the RAB to the extent that we are satisfied that:

- it meets the prudent cost condition<sup>2</sup> – broadly speaking, capital expenditure meets the prudent cost condition if it was incurred in connection with the design, engineering and construction of the relevant assets under a 'conforming contract'<sup>3</sup> (that is, generally, in accordance with the procurement rules); or in an open and competitive market; or through another 'value for money' process. The SAU requires NBN Co to develop procurement rules that establish procurement processes that seek to generate an efficient and competitive outcome and reflect good industry practice; and
- it meets the prudent design condition<sup>4</sup> – capital expenditure meets the prudent design condition if it is 'materially consistent' with the network design rules<sup>5</sup> or a

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<sup>2</sup> See clause 1D.3.2(a)(i)(A)

<sup>3</sup> Clause 1D.4.1(a)(i)(B) contains additional requirements where there is a material change of circumstances affecting the Conforming Contract.

<sup>4</sup> See clause 1D.3.2(a)(i)(B)

<sup>5</sup> The document describes the design of NBN Co's network and network components. Capital expenditure must be in accordance with the Network Design Rules in order to be included in the Regulated Asset Base, in addition to meeting the 'Prudent Cost' condition. The Network Design Rules were updated on 30 June 2015.

permitted variation, endorsed network change or ACCC approved network change to the network design rules,<sup>6</sup> or

- it was incurred in connection with some specific prudent cost categories listed in the SAU – that is, capital expenditure is considered to be prudent under the SAU if it relates to: the Telstra or Optus arrangements, interim satellite or transit arrangements, Tasmania tri-area service arrangements, trial sites, or third party funded network changes; or was incurred prior to the approval of the SAU on 13 December 2013.<sup>7</sup>

Operating expenditure may only be included in the ABBRR to the extent that we are satisfied that:

- it was incurred in accordance with NBN Co's procurement processes (including in accordance with the procurement rules), was incurred pursuant to a 'conforming contract', was procured in an open and competitive market, or was procured in a manner that is likely to achieve value for money,<sup>8</sup> or
- it was incurred in connection with some specific procurement cost categories listed in the SAU – that is, operating expenditure is considered to be prudent under the SAU if it relates to: the Telstra or Optus arrangements, interim satellite or transit arrangements, Tasmania tri-area service arrangements, trial sites, or third party funded network changes; or was incurred prior to the approval of the SAU on 13 December 2013; or it was required to address an urgent network issue or a force majeure event.

We must have regard to the regulatory information submitted by NBN Co and must also follow the decision making process set out in the SAU. If we are not satisfied that the values proposed by NBN Co comply with the SAU provisions, we may determine values for the ABBRR, RAB and ICRA that are different from the values submitted by NBN Co, provided that those values are determined in accordance with schedules 1D and 1E of the SAU.<sup>9</sup> The SAU includes provisions which set out the factors to consider when determining a substitute amount of capital or operating expenditure.<sup>10</sup>

We must notify NBN Co of our preliminary view on capital and operating expenditure within 40 business days of receiving the regulatory information. We must also consult publicly on a draft LTRCM determination before making a final LTRCM determination. The final determination must be published by 30 June 2017.

### ***Regulatory information***

Schedule 1F of the SAU sets out the regulatory information NBN Co must provide to the ACCC during the initial regulatory period.

By 30 June prior to the commencement of each financial year, NBN Co must submit forecast financial information to the ACCC. This information must contain NBN Co's forecasts or estimates of capital expenditure (by asset type), operating expenditure, disposals (by asset

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<sup>6</sup> Clause 1D.6 of the SAU.

<sup>7</sup> Schedule 1D of the SAU.

<sup>8</sup> See clauses 1E.8.2(a)(i) and 1E.8.3.

<sup>9</sup> See clause 1E.1.2(c)(iv) of the SAU.

<sup>10</sup> See clauses 1D.3.2(d) and 1E8.2(c). For example, a substitute amount of capital expenditure determined by the ACCC must meet the Prudent Design Condition and must be consistent with capital expenditure that has been included in the RAB in respect of any prior financial year, having regard to the relative amounts of capital expenditure incurred in those years, the relative cost of goods and services in those year, any relevant differences in the scale and scope of the relevant assets, the NBN Co Corporate Plan and any other matter the ACCC considers relevant.

type) and the opening and closing values of construction in progress. This forecast financial information is confidential of particular sensitivity.

By 31 October each year, NBN Co must submit:

- Actual financial information - including operating expenditure, capital expenditure and revenue.
- Proposed financial information - including NBN Co's proposed values for the ABBRR, RAB and ICRA.
- Statement of material variances – showing the variances between the forecast financial information and actual financial information, including reasons for the variances.
- Expenditure compliance report – a certification from NBN Co's CFO regarding the basis on which NBN Co's capital expenditure and operating expenditure meet the relevant prudency conditions in the SAU.
- Procurement rules compliance report – a certification from NBN Co's Chief Procurement Officer (CPO) regarding the basis on which NBN Co's procurement rules meet the relevant conditions set out in the SAU.
- Price compliance report – a certification from NBN Co's CFO regarding the basis on which the pricing of NBN offers and other charges meet the relevant conditions as set out in the SAU.

In the past, NBN Co has also provided additional materials to support its submission. This has included three independent assurance reports from PricewaterhouseCoopers (PwC), a price compliance spreadsheet, an LTRCM spreadsheet and a copy of NBN Co's current Chart of Accounts. Some of the public materials provided by NBN Co have been redacted to remove information with status 'confidential' or 'confidential of particular sensitivity'.