



NBN Co Special Access Undertaking

Long Term Revenue Constraint Methodology
2018-19: Final Determination

and

Price compliance reporting 2018-19

26 June 2020

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1. Introduction

In accordance with schedule 1E.1.2 of NBN Co's special access undertaking (the SAU), the ACCC has made a final determination in relation to NBN Co's long term revenue constraint methodology (LTRCM) for the 2018-19 financial year.

The ACCC has considered the regulatory information submitted by NBN Co for the 2018-19 financial year and assessed the various components against the relevant requirements of the SAU to reach this determination. Based on its assessment, the ACCC has determined that the values proposed by NBN Co for allowable revenues, the regulatory asset base (RAB), initial cost recovery account (ICRA), and all associated inputs have been determined in accordance with the requirements set out in the SAU. The ACCC is satisfied that prudence requirements for expenditure have been met, and that NBN Co's prices did not exceed maximum regulated prices (MRP) at any point during the 2018-19 financial year.

1.1. The LTRCM process

NBN Co's SAU is a key component in the framework used to regulate the National Broadband Network (NBN) and will apply until June 2040.

The SAU establishes the LTRCM, which is a methodology used to determine NBN Co's annual regulated revenue, regulated asset base and the account for accumulating initial unrecovered costs that NBN Co can recover later in the SAU period. The LTRCM provides NBN Co with the opportunity (but not certainty) to recover its prudent and efficient costs of supply, including allowing for an appropriate return on investment. The LTRCM also provides NBN Co with incentives to incur only efficient expenditure and to price reasonably to promote the long-term interests of end users.¹

As set out in the SAU, the ACCC is required to undertake a number of steps before making a LTRCM final determination for the relevant period. These include receiving NBN Co's submission of regulatory information, publishing a preliminary view on capital and operating expenditure, publishing a draft determination and finally publishing a final determination.

The LTRCM process for the relevant period commences once NBN Co has submitted certain regulatory information to the ACCC including financial information that is necessary to determine its allowed revenue. NBN Co must also certify that its prices have not exceeded the MRP dictated by the SAU at any point during the relevant financial year.

The ACCC's role in considering the LTRCM is to:

- assess whether NBN Co's capital expenditure and operating expenditure meet the relevant requirements in the SAU for inclusion in the RAB and ABBRR
- assess if the relevant LTRCM components have been calculated in accordance with the formulas set out in the SAU, and
- determine whether the expenditures (as set out in NBN Co's LTRCM proposal) should be included in the LTRCM determination.²

The ACCC may determine LTRCM values that differ from those submitted by NBN Co as long as the values are determined in accordance with schedule 1D and schedule 1E of the

¹ ACCC, *NBN Co Special Access Undertaking Final Decision*, 13 December 2013, pp. 11-12.

² For more detail on each of these LTRCM assessment requirements see ACCC, *2017-18 LTRCM draft determination*, pp. 8-9.

SAU.³ The factors that the ACCC must consider when determining a substitute amount of capital expenditure or operating expenditure are set out in the SAU.⁴

1.2. Overview of the 2018-19 LTRCM process to date

On 31 October 2019, NBN Co submitted its regulatory information for the 2018-19 financial year.

On 20 December 2019, the ACCC provided NBN Co with its preliminary view that it does not intend to determine a substitute amount of capital expenditure in accordance with clause 1D.3.2(d) or a substitute amount of operating expenditure in accordance with clause 1E.8.2(c) of the SAU. Our preliminary view also set out some longer-term issues that we proposed to consider and invited feedback on these matters.⁵ We received one submission from Telstra that raised broad concerns relating to NBN Co's cost recovery and some aspects of the LTRCM that it considered could be improved to remain fit-for-purpose.⁶

On 1 May 2020, the ACCC published its draft determination and invited further submissions, including on the issues raised by Telstra. We received a submission from ACCAN that supported the need for the LTRCM assessment process to evolve along with some other more specific concerns (these are discussed in section 4 of this report).

Longer-term issues for consideration and the impact of COVID-19

Our preliminary view noted that NBN Co is nearing the completion of the rollout, and will transition towards a more business-as-usual state with a stronger focus on service delivery. We also noted NBN Co's expansion into business-grade and enterprise services.

To appropriately capture these developments and ensure ACCC oversight and transparency of NBN Co's expenditure and revenues remain fit for purpose, we proposed a number of longer term issues that we considered could be covered in our LTRCM process. These matters included ACCC oversight of NBN Co expenditure post-rollout, transparency and revenue costs of individual services, price control compliance.

As set out in our draft determination, we decided not to pursue these proposed further changes within the 2018-19 LTRCM process given the impact of COVID-19. This reflects the ACCC's broader position on regulatory matters during this period and is consistent with the ACCC's recent decision to pause its inquiries into NBN wholesale service standards and NBN access pricing.⁷ We will look to commence our consideration of these matters following the 2018-19 LTRCM process (see section 4 for further discussion).

1.3. Structure of this report

This report outlines the ACCC's LTRCM final determination and view on NBN Co's price compliance for the 2018-19 financial year. The structure of this report is as follows:

- Section 2 provides an overview of the regulatory information submitted by NBN Co
- Section 3 outlines the ACCC's LTRCM draft determination
- Section 4 discussed the submissions to the draft determination and the ACCC's views on these submissions, and

³ Clause 1E.1.2(c)(iv) of the SAU

⁴ In determining a substitute amount, the ACCC must have regard to expenditure from previous years and adjust for relevant factors. See clauses 1D.3.2(d) and 1E8.2(c) of the SAU.

⁵ ACCC, *LTRCM 2018-19 ACCC preliminary view note*

⁶ Telstra's submission is available on the ACCC's LTRCM 2018-19 website.

⁷ ACCC, *2018-19 LTRCM draft determination*, 1 May 2020, p. 3.

- Section 5 presents the ACCC's LTRCM final determination and assessment of NBN Co's price compliance for 2018-19.

2. NBN Co's 2018-19 regulatory information

On 31 October 2019, NBN Co submitted its regulatory information for the 2018-19 financial year. This information consisted of NBN Co's actual and proposed financial information, an expenditure compliance report, a procurement compliance report, and a price compliance report.

NBN Co also submitted three independent reports from PricewaterhouseCoopers (PwC), a price compliance spreadsheet, an LTRCM spreadsheet and a copy of its chart of accounts. The ACCC has published public versions of NBN Co's regulatory information on the ACCC website.⁸

2.1. Expenditure compliance

NBN Co's regulatory information included an expenditure compliance report for 2018-19, pursuant to clause 1F.2.1(a) of the SAU. This report contained certification from NBN Co's CFO that NBN Co's proposed capital and operating expenditure complies with the relevant expenditure conditions set out in the SAU.

As in previous years, NBN Co engaged PwC to perform an independent limited assurance review in relation to the design of controls applicable to capital and operating expenditure prudence. PwC's report expresses an unqualified opinion and complements the certification from NBN Co's CFO.

In its regulatory information, NBN Co submitted a procurement rules compliance report in accordance with clause 1F.2.3(a) of the SAU. The report contained a certification from NBN Co's Executive General Manager (EGM) Procurement that NBN Co has developed and maintained Procurement Rules that satisfy the relevant conditions in clause 1D.5.1 of the SAU.⁹

2.2. Financial information

In addition, NBN Co submitted its actual and proposed financial information for the 2018-19 financial year. This submission consisted of the following six schedules:

- Schedule 6 – Statement of Capital Expenditure, Disposals, Construction in Progress, Asset Lifetimes and Taxation Asset Lifetimes
- Schedule 7 – Statement of Operating Expenditure
- Schedule 8 – Statement of Interest Expense
- Schedule 9 – Statement of Revenue
- Schedule 10 – Statement of LTRCM and RAB items, and
- Schedule 11 – Statement of Material Operating Expenditure, Capital Expenditure and Construction in Progress Variances.

NBN Co also submitted an LTRCM spreadsheet that set out the underlying calculations of NBN Co's proposed ABBRR, RAB and ICRA values.

⁸ See: <https://www.accc.gov.au/regulated-infrastructure/communications/national-broadband-network-nbn/nbn-co-special-access-undertaking/ltrcm-2018-19>

⁹ NBN Co, 2018-19 Regulatory Information – Actual and Proposed Financial Information, p. 16. NBN Co's EGM Procurement role succeeds the Chief Procurement Officer role.

We have summarised the key financial information submitted by NBN Co for the 2018-19 LTRCM determination (table 2.1) along with a comparison of the percentage change of the corresponding values in the previous period.

Table 2.1: Summary of NBN Co's financial information, 2017-18 and 2018-19 (nominal)¹⁰

	2017-18 (\$'000)	2018-19 (\$'000)	Percentage change
Operating expenditure	4 322 534	4 454 260	3%
Capital expenditure	6 148 060	5 766 682	-6%
Construction in progress (start of period)	3 739 873	3 182 847	-15%
Interest expense	69 905	351 672	403%
Revenue	1 978 206	2 824 879	43%
Unrecovered costs	4 558 368	4 846 872	6%
RAB (end of period)	19 379 004	23 330 671	20%
ABBRR	6 536 574	7 671 752	17%
ICRA (end of period)	19 405 530	25 458 678	31%

Source: LTRCM spreadsheet 2018-19

NBN Co also lodged three independent assurance reports from PwC to support its actual and proposed financial information submissions. This includes:

- a reasonable assurance audit report for Schedules 6 to 9: PwC's opinion in this report was unqualified and complements the audit of NBN Co's general purpose financial statements
- a factual findings of agreed upon procedures report for Schedule 10: PwC checked that the relevant values for previous years were in accordance with the 2017-18 LTRCM determination, that the relevant input values for 2018-19 were correctly extracted from Schedules 6 to 9 into the LTRCM spreadsheet, and that the relevant LTRCM calculations were undertaken in accordance with the SAU, and
- a limited assurance engagement on the design and implementation of controls around expenditure compliance in relation to NBN Co.

2.3. Price compliance reporting

In its regulatory information, NBN Co submitted a price compliance report and a price compliance spreadsheet for the period from 1 July 2018 to 30 June 2019.¹¹

The price compliance report provides certification from NBN Co's CFO that the pricing of NBN offers and other charges over the period from 1 July 2018 to 30 June 2019 satisfied the relevant requirements in Schedule 1C of the SAU.¹² The report does not identify any exceptions although there is some qualifying language that expresses negative assurance

¹⁰ These figures have been rounded to whole numbers. Note, figures have also been rounded throughout the document where appropriate.

¹¹ Pursuant to clause 1F.3(a) of the SAU.

¹² The certification provided by NBN Co's CFO was informed by a range of investigations and testing conducted by NBN Co. this is set out in more detail in the ACCC, *2018-19 LTRCM draft determination*, 1 May 2020, p. 19.

conclusions, similar in nature to the expenditure compliance report and the procurement rules compliance report.¹³

3. Overview of ACCC's draft determination

On 1 May 2020, the ACCC published the 2018-19 LTRCM draft determination.

The ACCC's draft determination proposed to accept NBN Co's proposed values (and inputs to the values) for the ABBRR, RAB and ICRA. The draft determination set out the ACCC's detailed assessment of NBN Co's regulatory information, which was submitted under Schedule 1F of the SAU. The ACCC's draft view was that:

- NBN Co had incurred capital and operating expenditure in accordance with the relevant provisions of the SAU
- NBN Co's proposed LTRCM values had been calculated in accordance with Schedules 1D and 1E of the SAU, and
- NBN Co's prices had not exceeded the maximum regulated levels set out in Schedule 1C of the SAU.

This section summarises the ACCC's draft determination.

3.1. Expenditure compliance and reporting

3.1.1. Expenditure compliance

The ACCC assessed NBN Co's expenditure compliance by considering the expenditure compliance report signed by NBN Co's CFO, PwC's limited assurance reports and NBN Co's supporting submission. The ACCC's draft decision was that NBN Co's expenditure has complied with the relevant prudency conditions in the SAU.

The expenditure compliance report did not identify any exceptions during the 2018-19 financial year and expressed a negative assurance conclusion.¹⁴ The ACCC also considered NBN Co's other supporting materials to determine the extent to which it could rely on the certification.

The ACCC checked that NBN Co's procurement guidelines complied with the relevant provisions of the SAU, as well as considered NBN Co's procurement rules compliance report to determine whether NBN Co had developed appropriate procurement rules.

The ACCC considered PwC's limited assurance report on the design of controls for expenditure compliance to determine whether there are processes and controls in place to support compliance with the prudency conditions in the SAU. The PwC report expressed an unqualified limited assurance conclusion.

The ACCC also considered NBN Co's supporting submission, which outlined its internal audit work, in order to assess whether NBN Co complied with these processes and controls.

¹³ Negative assurance is a technique commonly used by auditors to provide a representation that particular facts are believed to be accurate since no conflicting/contrary evidence has been found. NBN Co has had regard to Australian Standard on Assurance Engagement (ASAE) 3150 "Assurance Engagements on Controls" in developing the qualifying language in the certification. Further, NBN Co has submitted that PwC's independent assurance report audit has been conducted under (ASAE) 3150. See NBN Co, 2018-19 Regulatory information - Supporting submission, p. 15.

¹⁴ See footnote 13 for a detailed explanation of NBN Co's use of qualifying language and negative assurance.

3.1.2. Procurement compliance

The ACCC considered that NBN Co had provided a procurement rules compliance report that meets the requirements of the SAU.

The procurement rules compliance report did not identify any exceptions for the 2018-19 financial year and expresses a negative assurance conclusion. The ACCC also considered the material in NBN Co's supporting submission outlining what has informed the EGM Procurement's certification.

Based on this consideration, the ACCC is satisfied with NBN Co's procurement compliance for the purposes of the LTRCM determination.

3.2. Financial information

The ACCC considered NBN Co's regulatory information and considered that NBN Co had calculated its proposed values for the RAB, ABBRR and ICRA in accordance with the formulas in Schedules 1D and 1E of the SAU. Therefore, the ACCC's draft decision was to accept NBN Co's proposed values for the RAB, ABBRR and ICRA without amendment.

The ACCC considered NBN Co's actual and proposed financial information in assessing whether NBN Co had calculated its proposed LTRCM values in accordance with schedules 1D and 1E of the SAU. The ACCC also had regard to NBN Co's LTRCM spreadsheet, which sets out the inputs and calculations used by NBN Co to determine its proposed values for the RAB, ABBRR and ICRA. In making its draft decision, the ACCC reviewed the calculations NBN Co submitted in its LTRCM spreadsheet and confirmed that the formulas used in the spreadsheet were as set out in schedule 1E of the SAU.

Further, the ACCC considered the independent assurance reports from PwC and the statement of material variances, which support NBN Co's financial reporting.

The declaration provided by NBN Co's CFO and the independent assurance reports from PwC provide the ACCC with assurance that NBN Co's financial information has been prepared in accordance with the relevant provisions of the SAU.

NBN Co's regulatory information included a statement of material variances (Schedule 11), in accordance with clause 1F.1.3(b) of the SAU. The ACCC has reviewed Schedule 11 and is satisfied that it does not raise any significant concerns regarding the magnitude of capital and operating expenditure.

3.3. Price compliance

The ACCC considered NBN Co's price compliance report and its supporting submission. The ACCC was satisfied that NBN Co's prices in 2018-19 did not exceed the MRP set out in Schedule 1C of the SAU.

The ACCC undertook analysis of the price compliance spreadsheet submitted by NBN Co. We reviewed the prices listed in the spreadsheet and compared them to Schedule 1C of the SAU. We did not find any instances in which the listed prices exceeded the applicable MRP.

The ACCC was satisfied that NBN Co's price compliance report and supporting submission provide assurance that NBN Co has key control procedures in place to ensure that the prices for NBN Co's products do not exceed the applicable MRP. Our analysis of the price compliance spreadsheet supported this conclusion. Therefore, the ACCC was satisfied that NBN Co has met its price compliance obligations in the SAU.

4. Submissions to the 2018-19 LTRCM process

The ACCC received a submission from the Australian Communications Consumer Action Network (ACCAN) in response to its 2018-19 LTRCM draft determination and a submission from Telstra in response to the preliminary view on expenditure.¹⁵

4.1. Overview of submissions

ACCAN submitted that the LTRCM process needed to be reviewed to ensure that consumer's interests are protected and that as the COVID-19 health crisis has somewhat improved, these longer-term matters should now be considered.

ACCAN's submitted that NBN Co's reporting requirements should be reconsidered to increase transparency and provide more detail to determine whether cross subsidisation (from the residential to enterprise market) has occurred. ACCAN considered that at the very least NBN Co's reporting requirements should be segmented so that oversight was possible between residential and enterprise reporting but if possible, segmentation by technology and geography would be better.

ACCAN also submitted on the NBN Co's WACC figure. It stated that this figure does not accurately reflect NBN Co's true cost of capital, which could inflate NBN Co's allowable revenue amount. This would in turn provide less of a revenue constraint that could result in NBN Co charging more for the use of its infrastructure and pursue profit maximisation at the detriment of the LTIE.

ACCAN also notes the consequences of COVID-19 have emphasised the importance of affordable access to telecommunications and the importance of the regulatory environment in protecting consumer outcomes. ACCAN also noted the reasonableness of halting inquiries and decisions in the early phases of the COVID-19, but also that ACCC should resume these activities as the situation recovers.

In its submission to the preliminary view, Telstra raised concerns about the use of a commercial cost of capital in the LTRCM given its lower expected internal rate of return and that prioritisation of social objectives has meant it cannot be assumed all expenditure has been incurred commercially. It also reiterated concerns about transparency between commercial and non-commercial activities and the need for additional measures.

4.2. ACCC comments on submissions

The submissions received from Telstra and ACCAN during the 2018-19 LTRCM process raise important issues. These issues are not confined to the 2018-19 LTRCM process, but relate to more broadly to the LTRCM more generally, the overall SAU framework for cost recovery, transparency between commercial and non-commercial activities and associated transparency measures.

We note that the approach for calculating NBN Co's cost of capital was established in 2013 when the SAU was accepted by the ACCC and will remain in place until the end of module 1 in 2023. The approach in module 1 provides for a cost of capital equal to the risk-free rate plus a 350 basis point premium. This provides a balance between providing regulatory certainty to NBN Co about how the cost of capital will be determined and allowing the cost of capital to reflect changing market conditions through the risk-free rate.

¹⁵ Both submissions are available on the ACCC, *LTRCM 2018-19* website: <https://www.accc.gov.au/regulator-infrastructure/communications/national-broadband-network-nbn/nbn-co-special-access-undertaking/ltrcm-2018-19>

The approach to the cost of capital in module 1 is based on a benchmark of commercial costs of capital used in other regulatory decisions. We note that using a benchmark commercial cost of capital is consistent with the approach used by regulators more generally and other regulatory decisions by the ACCC and AER. However, there will be more flexibility with how NBN Co's cost of capital will be set in module 2. The ACCC will consider its approach to assessing NBN Co's cost of capital further in the lead up to module 2, taking into account comments made by ACCAN and Telstra and feedback received in any further consultation.

In relation to the appropriate recognition and distinction of commercial and non-commercial costs, we agree that additional transparency are likely to be desirable. Although the current LTRCM reporting requirements have provided an appropriate basis for the ACCC to make its LTRCM determinations, we agree with Telstra that current arrangements do not provide for the identification of costs and revenues associated with different services. It is unclear at this stage whether the LTRCM process itself is the best mechanism for identifying these costs and revenues or whether other measures will be required.

We also note there are or have been other mechanisms in place relating to the identification and allocation of costs and revenues. We note that the Regional Broadband Scheme will come into effect on 1 July 2020. A key element of this scheme is to identify and quantify the extent of NBN Co's non-commercial costs. We also note that NBN Co has been required under previous versions of the statement of expectations to provide accounting separation reports to the government.

We propose to commence a more detailed assessment and industry engagement on transparency requirements between commercial and non-commercial services in the second half of 2020. As part of this assessment, we will consider the role of the regional broadband scheme in providing this function and the previous accounting separation requirements on NBN Co in order to identify whether additional measures are required.

4.3. LTRCM decision

The ACCC maintains the views set out in its LTRCM draft determination. The ACCC's LTRCM final determination for 2018-19 is to accept NBN Co's proposed values (and the inputs to those values) for the ABBRR, RAB, and ICRA without modification, in accordance with clause 1E.1.2 of the SAU. Regarding price compliance, the ACCC is satisfied that NBN Co's prices for 2018-19 did not exceed the applicable MRP in accordance with Schedule 1C of the SAU.

5. The ACCC's LTRCM final determination

The ACCC has determined the values in Table 5.1 for the purposes of the 2018-19 LTRCM final determination. We have derived these values from the regulatory information provided by NBN Co.¹⁶

The ACCC is also satisfied that NBN Co's prices for 2018-19 financial year did not exceed the MRP applicable at any point in time, in accordance with schedule 1C of the SAU.

Table 5.1: 2018-19 LTRCM final determination¹⁷

Year	2018-19
CPI and Cumulative Inflation Factor	
June Quarter CPI (annual percentage change) – as per Attachment C to the SAU	1.593%
Cumulative Inflation Factor – as per Clauses 1E.9.4(b) and (c)	1.084
Rate of Return – as per Clause 1E.7.1	
Risk free rate of interest – as per Clause 1E.7.1(b) and (c)	2.716%
Nominal rate of return – as per Clause 1E.7.1(a)	6.216%
Regulatory Asset Base (\$'000 REAL) – as per Clause 1D.2.1	
Real RAB (start period) – as per Clause 1D.2.1(a) and (b)	18 161 385
Real capital expenditure	5 319 614
Real disposals	-
Real straight line depreciation	1 959 064
Real RAB (end period) – as per Clause 1D.2.1(b)	21 521 935
Regulatory Asset Base (\$'000 NOMINAL) – as per Clause 1D.2.2	
Nominal RAB (start period) – as per Clauses 1D.2.1(a) and 1D.2.2	19 379 004
Nominal straight line depreciation (as per Clause 1E.9.1(b))	2 123 707
Nominal RAB (end period) – as per Clause 1D.2.2	23 330 671
ABBRR (\$'000 NOMINAL) – as per Clause 1E.4.1	
Return on capital	1 204 626
Nominal regulatory depreciation – as per clause 1E.9.1(c)	1 815 015
Nominal operating expenditure	4 454 260
Net tax allowance	-
Annual construction in progress allowance – as per Clause 1E.10	197 850
ABBRR	7 671 752

¹⁶ In accordance with Clause 1E.1.2(c)(vi) of the SAU.

¹⁷ The clause references in this table refer to the formulas in the SAU. Note: figures have been rounded.

Taxation calculations (\$'000 NOMINAL) – as per Clause 1E.9.3	
Nominal revenue	2 824 879
<i>Add</i> value of assets received for nil consideration	141 252
<i>Less</i> nominal operating expenditure	4 454 260
<i>Less</i> nominal tax depreciation	2 058 752
<i>Less</i> interest expense	351 672
Taxable profit – as per Clause 1E.9.3	(3 898 552)
Tax loss carried forward (Start period) – as per Clause 1E.9.3	(13 878 209)
Tax loss carried forward (End period) – as per Clause 1E.9.3	(17 776 762)
Net tax allowance – as per Clause 1E.9.3	-
ICRA and CFRA (\$'000 NOMINAL) – as per Clause 1E.5	
ICRA (start period) – as per Clause 1E.5.2	19 405 530
Unrecovered cost – as per Clause 1E.5.1	4 846 872
ICRA (end period) – as per Clause 1E.5.2	25 458 678
Carry forward revenue adjustment – as per Clause 1E.5.3	n/a