Bringing broadband to life

15 February 2013

Mr Richard Home
General Manager, NBN Engagement and Group Coordination Branch
Australian Competition and Consumer Commission
Level 35, The Tower
360 Elizabeth Street
Melbourne VIC 3000

Dear Richard,

NBN Co Special Access Undertaking – Request for Further Information

We refer to your 29 January 2013 request for further information to assist the ACCC in its assessment of NBN Co's Special Access Undertaking (SAU), lodged with the ACCC on 18 December 2012.

NBN Co notes the ACCC's view that quantitative analysis of the price controls and long term revenue constraint proposed in the SAU is a necessary input to making an informed decision about whether it can be satisfied that the SAU meets the statutory criteria in section 152CBD of the CCA.

NBN Co's response to the ACCC's information request covers three areas: the detailed information requested by the ACCC; confidentiality arrangements to facilitate sharing of confidential information with interested parties; and other relevant considerations for the ACCC's assessment of the SAU.

At the outset, NBN Co would like to highlight that when interpreting any quantitative analysis of the price controls and long term revenue constraint, it is important to also consider the nature and extent of NBN Co's pre-existing incentives to act efficiently. These incentives are a product of NBN Co's wholesale-only structure and its commercial context, with NBN Co's Corporate Plan assuming increasing average revenue per user over time via take-up of higher access speeds and increasing data usage.

Detailed information requested by the ACCC

The ACCC has requested actual and forecast price, demand, revenue and expenditure information for the period from 2008-09 to 2039-40 under two pricing scenarios:

- price paths as in the 2012-15 Corporate Plan (Corporate Plan pricing scenario); and
- the maximum price paths allowed by the SAU (maximum pricing scenario).

Attachment A to this letter, which is confidential, sets out the detailed information for the two pricing scenarios. Attachment B, which is not confidential, describes the basis on which NBN Co has prepared the detailed information.

Confidentiality arrangements

As requested by the ACCC, NBN Co has established confidentiality arrangements to facilitate sharing of confidential information with interested parties.

The contents of this letter and Attachment B are not confidential, and may be published on the ACCC's website.

Interested parties who would like to request access to Attachment A should contact:

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Requests will be considered on a case by case basis.

Other relevant considerations

NBN Co has prepared the following material to assist the ACCC in using the information in Attachments A and B in its assessment of the SAU.

Note that while a number of scenarios are discussed below, NBN Co makes no representation about the merits or likelihood of any of the scenarios actually eventuating – indeed, given the 30 year forecast horizon, it would not be reasonable or appropriate for NBN Co to do so.

The operation over time of the Long Term Revenue Constraint Methodology

NBN Co highlighted in its 14 January 2013 response to Optus (available on the ACCC's website) that the design of the SAU does not depend on any particular assumption regarding when, or if, the ICRA will be extinguished.

Depending on the scenario and its associated assumptions, the Initial Cost Recovery Account (ICRA) may or may not be forecast to be extinguished by 2039-40.

NBN Co has previously advised that if the base case assumptions in the 2012-15 Corporate Plan are modelled, the ICRA would not be extinguished by 2039-40.

Under a scenario in which prices were instead increased to the maximum extent allowed by the SAU (that is, by CPI-1.5% per year in most situations), the ICRA would still not be extinguished by 2039-40, and indeed the forecast ending value of the ICRA would be <u>higher</u> than under the Corporate Plan scenario. This is because the cumulative effect of the maximum price increases is modelled to lead to an adverse demand response that would be manifested in:

- fewer subscribers to the NBN (primarily due to increased wireless-only substitution);
- lower average access speeds (as end-users take up more entry-level and lower speed services than they would otherwise have done); and
- lower average data usage (as only smaller data quotas are affordable).

The nature and extent of the demand response in this scenario would outweigh the effect of higher prices, such that NBN Co's total revenue would be materially lower than in the Corporate Plan pricing scenario.

However, if no demand response is factored into the maximum price scenario, then a very different outcome emerges; that is, assuming that quantities demanded are the same as in the Corporate Plan, forecast revenue is much higher and this leads to the ICRA being extinguished some years before end of the SAU in 2039-40.

Under a scenario in which prices are held flat in nominal terms (and again assuming that quantities are the same as in the Corporate Plan; that is, there is no adverse demand response from higher prices than those projected in the Corporate Plan), the ICRA is also forecast to be extinguished before 2039-40.

Note that both of these additional scenarios are simple to prepare using the detailed information in Attachment A. Again, no representation is being made as to the viability or likelihood of any of these scenarios actually occurring – all that is being described here are the implications for the ICRA should they occur.

Although the timing of ICRA extinguishment is necessarily uncertain, this adds to rather than detracts from the reasonableness of the SAU as its reflects a long term revenue sufficiency risk that creates positive incentives for NBN Co given its wholesale-only status.

In its authorisation of NBN Co's agreement with Optus[1], the ACCC acknowledges the role of revenue sufficiency risk in creating incentives for NBN Co to keep costs to efficient levels and to encourage take-up of higher speed services and greater usage. This revenue sufficiency risk will, more generally, complement the SAU's terms and conditions by reinforcing the incentives for NBN Co to act efficiently, including in regard to its expenditure, investment decision making, product development, pricing, service levels, and customer engagement (including on such matters as non-price terms).

The existence of revenue sufficiency risk is apparent in the range of revenue scenarios described above (based on the detailed information in Attachment A) and it should be noted that the full range of revenue scenarios is potentially much wider.

In the event that NBN Co appears to be closing in on ICRA extinguishment, there will be a particular incentive (related to revenue sufficiency risk and ongoing revenue stability and predictability) to engage with access seekers regarding how best to manage the transition of prices between the Initial Cost Recovery Period and the Building Block Period (and noting that if the transition were done abruptly, in a single year, the average decrease in NBN Co's prices would, in percentage terms, be well into double digits).

This incentive complements the specific commitments in the SAU that require NBN Co to notify its customers and the ACCC 5 years prior to the time that the ICRA is expected to be extinguished and then to provide more detailed information 3 years prior to extinguishment, including:

- Forecast average price change across all products;
- Expected impact on individual prices of each product; and
- Transitional arrangements that will be put in place.

[1] ACCC, Applications for Authorisation lodged by NBN Co Limited in respect of provisions of the HFC Subscriber Agreement entered into with Singtel Optus Pty Ltd and other Optus entities, 19 July 2012, p.iv.

The SAU also commits NBN Co to update this information each year so that access seekers will have appropriate visibility and certainty about the likely impact on prices well in advance of any changes that are made.

The appropriateness of NBN Co's price structures over time

As described in NBN Co's Supporting Submission[2], NBN Co's pricing strategy (as reflected in the AVC and CVC price structures and initial price levels) reflects the need to balance, over time, the competing needs of maintaining high rates of take-up of the NBN (through affordable AVC prices) with high rates of usage of the NBN (through affordable CVC prices). Striking an effective balance, and having the flexibility to adjust it dynamically, is very important for NBN Co, access seekers and their end-users given the extent of the economies of scale and scope associated with the NBN and also the need to account for evolving technology, applications and demand over the 30 year term of the SAU.

The outcomes from the scenarios described by NBN Co above highlight the limited freedom that NBN Co may have to adjust prices upwards, or to alter pricing structures, even in the absence of the SAU price controls. At the lower end of the market, substitutes are and will continue to be available in the form of mobile voice and broadband services. At the higher end, in respect of data usage in particular, NBN Co needs to set appropriate prices for its CVC over time or it will potentially face much lower than expected usage and revenue.

The appropriateness of the CPI-1.5% individual price increase limit

The CPI-1.5% limit on any individual price increase (applied on an annual 'use it or lose it' basis) is included in the SAU to provide stability and predictability to access seekers regarding the prices of individual services, and operates regardless of whether or not the ICRA is extinguished and the long term revenue constraint then becomes binding. It leaves NBN Co with some limited ability to change price relativities over time. As discussed above, NBN Co is likely to have limited freedom, due to commercial rather than regulatory considerations, to adjust prices upwards. In view of this, the individual price increase limit provides an additional degree of certainty to access seekers, but should not be seen as the only or even the prime constraint on NBN Co's likely future pricing behaviour.

A key aspect of the base case assumptions in NBN Co's 2012-15 Corporate Plan is significant assumed decreases in nominal prices over time as average access speeds and average data usage increase.

Based on these assumptions, some access seekers have suggested NBN Co should provide further price commitments in the SAU via a CPI-X cap on average revenue per user, at either a segment or an overall level, and/or a firm commitment to reduce CVC prices. Essentially, these access seekers want NBN Co to apply a dangerously simplistic approach of converting the current assumptions in the Corporate Plan into certain price commitments in the SAU.

Such requests for further price commitments miss a number of obvious points.

- First, the NBN is subject to a range of supply side and demand side uncertainties, leading to a range of possible upside and downside scenarios over the period to 2039-40. Deriving further, and more stringent, price commitments based on only one scenario (particularly one in which the ICRA is not extinguished) lacks any firm analytical foundations and appears likely to be inconsistent with the Long Term Revenue Constraint Methodology (which recognises that NBN Co should have the opportunity to

[2] Supporting Submission, p.100.

recover its prudently incurred costs of supply, inclusive of an appropriate return on capital). This is reinforced by the outcomes of the different scenarios provided by NBN Co in the detailed information in Attachment A, which can lead to markedly different revenue profiles over 30 years depending on the assumptions chosen. This highlights the hazard of calibrating the price controls to a single scenario of future revenue.

- Secondly, it is not clear what problem the further price commitments are intended to address. The price commitments NBN Co has made in the SAU (including the CPI-1.5% individual price increase limit with its 'use it or lose it' nature) adequately address access seekers' needs for pricing stability and predictability. If access seekers consider that this is not the case, such that they, their end-users or their suppliers are unable to make complementary investments necessary for the ongoing efficient use of NBN Co's services, then NBN Co suggests access seekers document and evidence their concerns in detail for both the ACCC and NBN Co.
- Thirdly, NBN Co considers that its interests are sufficiently aligned with those of access seekers for NBN Co to seek to ensure there is the right environment for complementary investments to take place. If such investments are not forthcoming, then this will clearly have a negative effect on the achievement of NBN Co's objectives, including its long term cost recovery. In this regard, the SAU is intended to provide a baseline level of pricing stability and predictability to access seekers, and it is conceivable that NBN Co may in future make additional price commitments (that is, beyond the CPI-1.5% individual price increase limit) if it believes this is necessary to provide an appropriate environment for complementary investments.

In regard to why NBN Co chose CPI-1.5% as the level of the individual price increase limit rather than, say, CPI-0%, CPI-3% or some other CPI-X% factor, NBN Co reiterates what it said in its 14 January 2013 response to Optus – it was not the result of modelling of NBN Co's costs and demand (that is, NBN Co did not derive CPI-1.5% from a particular scenario, or on the assumption that the ICRA is extinguished by a particular point in time).

Based on the above discussion of the operation of the Long Term Revenue Constraint Methodology, NBN Co clearly did not select CPI-1.5% on the basis that it currently intends raising prices by that amount each year in order to extinguish the ICRA by 2039-40 (under assumptions consistent with the 2012-15 Corporate Plan, such an approach is modelled to lead to significantly lower total revenues over time due to the significant adverse demand response). However, depending on how demand and cost conditions evolve over time, NBN Co may need to selectively adjust some individual prices within the individual price increase limit.

Given this, CPI-1.5% was selected as the level of the individual price increase limit because it strikes an appropriate balance between providing:

- NBN Co with some limited ability to change price relativities over time;
- access seekers with an appropriate baseline degree of pricing stability and predictability (noting that the SAU does not prevent NBN Co from making further price commitments over time); and
- NBN Co with the opportunity to recover its prudently incurred costs of supply (inclusive of an appropriate rate of return).

It is important to recognise that this balance can only ever be struck in an approximate manner, but that does not reduce the necessity of seeking to do so.

As always, we would be pleased to discuss this or any other SAU issue with you.

Yours sincerely,

Caroline Lovell

Caroline Lovell
Head of Regulatory Affairs and Industry Analysis