Submission in response to ACCC
Draft Determination

Long Term Revenue Constraint Methodology 2013-14

PUBLIC VERSION

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Contents

Section 1. EXECUTIVE SUMMARY

1.1 Optus welcomes the opportunity to provide comments on the assessment of the Long Term Revenue Constraint Methodology (LTRCM) for financial year 2013-14. This is the first compliance review conducted under the NBN Co Special Access Undertaking (SAU) and as a result, represents an important opportunity for the ACCC and industry to ensure that the SAU is working as intended and still promotes the long term interest of end-users (LTIE).

1.2 Since the approval of the NBN Co SAU in December 2013, there has been substantial change to the network design of the NBN; namely a move from a GPON FTTP architecture to a multi-technology mix (MTM), enabling deployment of fibre-to-the-node (FTTN), Hybrid Fibre-Coaxial (HFC), and fibre-to-the basement (FTTB) technologies. However, no change has been made to SAU or the Network Design Rules (NDR). For example, provisions in the SAU require that the fibre network be based on GPON FTTP architecture for 93% of households.[1] This has important implications for the assessment of prudency.

1.3 Optus has identified the following issues which have implications for the assessment of prudency:

(a) NBN Co has failed to update its NDR to reflect the MTM architecture, and yet MTM-related capital expenditure is still deemed prudent;

(b) Operating expenditure is prudent if consistent with the Procurement Rules, but these rules have never been made public so it is not possible for industry to provide input; and

(c) Compliance statements are highly qualified and provide little assurance of compliance.

1.4 In addition, Optus is concerned that the inconsistency between the SAU and the MTM NBN will be magnified for the assessment of prudency in 2014-15. Optus recommends that the SAU be amended to include provisions that are consistent with the current Statement of Expectations and MTM design. Alternatively, the ACCC should provide guidance on how it sees the current SAU operating in the MTM environment.

The SAU is not consistent with MTM

1.5 The SAU has not been updated to reflect the fundamental re-design of the NBN. This raises several compliance issues with the current LTRCM approach. A review of the mechanisms within the SAU clearly shows provisions that are potentially inconsistent with the MTM design and latest Statement of Expectations.

1.6 The NDR, which under the SAU are required to be updated to reflect any new Statement of Expectations, are yet to be changed some twelve months after it was issued. Further, clauses in the SAU arguably <u>prevent</u> the NDR from being updated as the SAU requires the network to be a GPON FTTP covering 93% of households.[2]

1.7 Insofar as the SAU requires the NDR to be updated and requires a GPON FTTP architecture, expenditure <u>cannot</u> be assessed as being prudent if it relates to FTTN, FTTB or HFC. Optus acknowledges the contradiction of this – that capex consistent with MTM cannot be

[1] Clause 1D.7.1
[2] Clause 1D.7.1

considered prudent even though it is significantly less than the costs which would be incurred under a GPON FTTP. This demonstrates the need for NBN Co to update the SAU to reflect the move to a MTM network architecture.

1.8 It is not clear from the Draft Determination and NBN Co documents the extent to which MTM-related expenditure has occurred during FY14. Optus has not had an opportunity to review the confidential material prior to this submission, and cannot provide specific comment.

1.9 Optus recommends that the ACCC request further information on MTM-related expenditure incurred.

Operating expenditure cannot be commented upon

1.10 While there are clearer rules around the prudency of capital expenditure, which can be assessed by interested parties, there is no opportunity to assess the prudency of operating expenditure.

1.11 The SAU requires that operating expenditure be deemed prudent if it is consistent with the Procurement Rules. These Procurement Rules have never been made public and have not been subject to any public consultation. Consequently, interested parties are not able to provide any comment on operating expenditure prudency.

1.12 The lack of consultation was not anticipated during the development of the SAU. Indeed, Optus expected an opportunity to comment on the development of the Procurement Rules.

1.13 The ACCC ought to be concerned with the lack of oversight over NBN Co's operating expenditure – an expense that will run into tens of billions of dollars over the lifetime of the SAU.

NBN Co compliance signoff is less rigorous than imposed on other operators

1.14 The drafting of the declarations put forward by NBN Co is significantly weaker than that put forward by other operators under the Telecommunications Industry Regulatory Accounting Framework (RAF).

1.15 For example, the compliance certificate states that nothing was brought to the attention of the CFO to suggest that expenditure was inconsistent with the NDR – yet the Statement of Expectations were changed in April 2014, thus making subsequent expenditure after this date potentially in breach of the SAU.

1.16 The SAU should not impose less onerous obligations than the RAF. The RAF has limited utility in price setting yet it has a clear and robust certification process. By contrast the LTRCM process, which sets out the long term cost recovery and hence price level to be faced by every fixed line end-user, has a weak certification process.

1.17 Optus submits that the ACCC should not accept the certification put forward by NBN Co as drafted. The ACCC should require NBN Co to sign compliance certificates consistent with that imposed under the RAF.

Section 2. CAPITAL EXPENDITURE

2.1 Capex may only be included in the Regulated Asset Base (RAB) to the extent that the ACCC is satisfied that it meets the Prudent Cost Condition (cl.1D.4) and the Prudent Design Condition (cl.1D.6).[3] Capex must comply with both conditions for inclusion in the RAB.

Prudent Design Condition

2.2 The Prudent Design Condition outlines the manner in which capex will satisfy the prudency requirement for inclusion in the RAB. There are three requirements:

(a) Consistent with the Network Design Rules clause 1D.7.1 and 1D.7.4;

(b) Within a scope of a permitted variation; or

(c) An endorsed network change.[4]

2.3 This section discusses whether NBN Co is compliant with the NDR.

2.4 Optus acknowledges that the drafting of cl.1D.6 poses some problems; it is not clear whether all or just one of the three conditions need to be complied with. While this is clearly an important legal question; it has less impact on Optus' central problem with the drafting of key requirements within the SAU – and the need for a substantial re-draft of the document.

Non-compliance with the Network Design Rules

2.5 Capital expenditure can be deemed prudent if it is incurred in a manner consistent with the NDR, clause 1D.7.1 and 1D.7.4. This section discusses the obligations set out in those clauses and whether capex can be considered consistent with the NDR.

2.6 Clause 1D.7.1 states that NBN Co is to ensure that the Network Design Rules satisfy the following scope:

(a) Fibre network is to have a footprint consistent with the Statement of Expectations as at 17 December 2010;

(b) Fibre network is to be primarily designed and built using GPON architecture. Where NBN Co has defined GPON as "a point to multi-point FTTP network architecture that uses combination of electronics network and passive optical splitters".[5] NBN Co has also stated that GPON is used for its FTTP network.[6]

(c) NBN Co Fibre Network is to be capable of delivering the speed requirements specified in the Statement of Expectations; and

(d) Compliant with the Statement of Expectations and policy requirements in respect of fibre in greenfields.

[3] Cl.1D.3.2
[4] Cl.1D.6
[5] NBN Co, Corporate Plan 2014-17, P.56
[6] Ibid.

2.7 This requirement was given effect through the NBN Co NDR (current version dated 1 July 2014).[7] The NDR have not yet been updated to reflect the MTM design. The introduction to the July 2014 NDR highlights that pursuant to the updated Statement of Expectations and the adoption of the MTM approach it is expected to be updated at some point in the future. The document states:

> *The planning to give effect to the 8 April 2014 Statement of Expectations is still underway and once this is complete a major update of the NDRs will be undertaken*.[8]

2.8 However, while it is flagged that the document will be updated, the NDR continues to reflect the GPON FTTP design on the original NBN. It does not matter whether, and when, a new NDR is to be produced. The SAU requires that prudency be assessed against the existing NDR at the time the capex was planned or incurred.[9] The relevant capex was that incurred during FY2014 – that is, before the additions made to the 1 July 2014 NDRs.

2.9 Further, Optus queries whether an updated MTM NDR can be consistent with the SAU – where the SAU specifically states that the NBN fibre network is to be primarily a GPON FTTP design. This issue again highlights that the current SAU is not consistent with a MTM NBN. As currently drafted, the SAU does not permit the NDR to be updated to reflect the latest Statement of Expectations and MTM design.

2.10 To that end, prudency must be assessed against the NDR requiring a GPON FTTP fibre network, with 93% fibre coverage. Any expenditure that relates to the MTM design of the NBN <u>cannot</u> be considered prudent under the SAU.

NBN Co must update Network Design Rules

2.11 The Prudent Design Condition requires that the NDR be consistent with 1D.7.4. Clause 1D.7.4 of the SAU requires that NBN Co <u>must</u> update its NDR to reflect a change to the design of the relevant assets in connection with any requirement of the Shareholder Ministers. Given the network changes in the latest version of the Statement of Expectations to reflect the move to the MTM NBN, NBN Co would be required under this clause to update the NDR.

2.12 The SAU also makes clear that capex incurred prior to the changes in the NDR must be assessed against the version of the NDR that applied at the time of expenditure.[10]

2.13 The process to update the NDR is outlined in clauses 1D.8 to 1D.11, covering the following:

(a) Selection and publication of preferred network change (1D.8);

(b) Engagement and endorsement process (1D.9);

(c) Dispute resolution mechanism (1D.10);

(d) Endorsed network change (1D.11).

2.14 Arguably, the NBN Co Strategic Review document could be considered to reflect the assessment of network change ensuring lowest cost of ownership and maximising economic benefits, as required under cl.1D.8 and 1D.12. However, it is not clear whether the other elements of the process have been adhered to. For example:

[7] http://www.nbnco.com.au/sell-nbn-services/special-access-undertaking-sau.html
[8] NBN Co, Network Design Rules, 1 July 2014, p.6
[9] Cl.1D.7.4(e)
[10] Cl.1D.7.4(e)

(a) Clause 1D.9 requires that NBN Co;

(i) Seek the endorsement of access seekers, consumer advocacy groups. This endorsement process is distinct and separate from the PDF, but may occur in parallel.[11]

(ii) Invite access seekers and consumer advocacy groups to make submission in relation to the Prudency Implementation Paper, providing a reasonable time for consultations.

(iii) Publish all formal written submissions received on NBN Co's website.

(iv) Provide a period of at least 20 days for access seekers and consumer advocacy groups to notify objections to the final NBN Prudency Implementation Paper

(b) Clause 1D.10 provides for a dispute resolution process that provides for assessment by the ACCC of the prudency of the proposed network changes.

(c) The network changes will be considered endorsed where the ACCC has accepted the network changes, or no access or consumer advocacy group has raised a network dispute.

2.15 Finally, absent network endorsement under cl.1D.10.5, the Preferred Network Change will not be considered to be endorsed by the ACCC and will therefore not satisfy the Prudent Design Condition for the purposes of a Network Change pursuant to clause 1D.6(c).

Assessing compliance with the Prudent Design Condition

2.16 The Prudent Design Condition requires capex to be consistent with the NDR (in force at the time capex was incurred) and within a permitted variation or an endorsed network change.

2.17 The relevant clauses in the SAU demonstrate that the NDR requires NBN fibre network to cover 93% of households using GPON FTTP architecture. This is not consistent with the MTM NBN network design. There has been no attempt by NBN Co to update the NDR (which is inconsistent with its SAU obligations) and there has been no endorsed network change.

2.18 It would, therefore, appear that any capex incurred in the pursuit of the MTM NBN design cannot be deemed consistent with the Prudent Design Condition.

2.19 Optus acknowledges the contradiction of this – that capex consistent with MTM cannot be considered prudent even though it is significantly less than the costs which would be incurred under a GPON FTTP. This demonstrates that the SAU needs to be revised to operate in a manner consistent with the MTM.

Prudent Cost Condition

2.20 One factor to be taken into account when assessing compliance with the Prudent Cost Condition is whether the capex relates to a contract entered into in accordance with the Procurement Rules.[12]

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[11] Cl.1D.9.1(b)

[12] Cl.1D.4.2(a)(i)

2.21 The Procurement Rules are an important document in the context of the SAU. This was highlighted by Optus during the development of the SAU. However, the Rules are not public, have not been consulted upon, and its compliance cannot be tested.

2.22 Optus therefore cannot comment on NBN Co's compliance with the Prudent Cost Condition since it is dependent on NBN Co's compliance with the Procurement Rules which have not been made public.

Section 3. OPERATING EXPENDITURE AND COMPLIANCE

3.1 This section outlines Optus' views on the prudency of NBN Co's operating expenditure and the adequacy of the compliance certificates issued by the CFO and Chief Procurement Officer.

Assessing operating expenditure

3.2 Operating expenditure can only be included in the ABBRR to the extent that the ACCC is satisfied that it complies with clause 1E.8, namely that it was:

(a) In accordance with the Procurement Rules, was procured in an open and competitive market, or was procured in a manner that is likely to achieve value for money; or

(b) Incurred in relation to the range of deemed prudent activities.

3.3 The Procurement Rules are not in the public domain and Optus has not had any opportunity to review the Rules. Therefore, it is not possible to provide a view on whether the operating expenditure complies with the Rules.

3.4 Optus has concerns over the process of assessing operating expenditure prudency. Operating expenditure will amount to many tens of billions of dollars and yet its prudency will never be subject to public consultation due to the confidential nature of the Procurement Rules.

3.5 The lack of transparency of the Procurement Rules was not anticipated during the development of the SAU. Indeed, while Optus raised many concerns over the reliance on the Procurement Rules when assessing prudency, it was never made clear during the SAU process that industry would not be consulted upon in relation to the Rules. This lack of transparency is not in the public interest.

Compliance certification

3.6 Clause 1F.2 outlines the expenditure compliance and reporting obligations. NBN Co has submitted compliance certificates by the CFO in relation to expenditure obligations, and the Chief Procurement Officer in relation to compliance with Procurement Rules.

3.7 The drafting of the compliance certificates contain strong qualifying language. This was noted in the Draft Determination. The certification states that it is on the "*basis that nothing has come to my attention that causes me to believe anything to contrary*".[13] This is far from a positive certification that expenditure was prudent.

3.8 The drafting of the certification under the SAU can be compared with the obligations placed upon network operators under the ACCC's Regulatory Accounting Framework (RAF) obligations. Schedule 9 of the RAF requires carriers' CFO and CEO to sign the following statement:

> *We declare that:*
>
> (a) *the reports are prepared in accordance with the requirements of the Rules;*
>
> (b) *the Manual is established and maintained in accordance with the Rules;*

[13] NBN Co, Expenditure Compliance Report.

(c) *the Manual has been appropriately updated to reflect changes in the business or structure of the carrier and the requirements of the Rules; and*

(d) *all reports are reconciled with the audited statutory financial statements.*

3.9 The drafting of this declaration is significantly stronger than that put forward by NBN Co.

3.10 The SAU should not impose less onerous obligations than the RAF – a reporting regime which has limited if any use by the ACCC for price setting. This can be compared to the LTRCM process which sets out the long term cost recovery and hence price level to be faced by <u>every</u> fixed line end-user.

3.11 Optus submits that the ACCC should not accept the certification put forward by NBN Co as drafted. ACCC should require NBN Co to sign compliance certificates consistent with that imposed under the RAF.