Bureau of Communications Research

NBN non-commercial services funding options

Consultation Paper

Response by iiNet

1. Introduction

The Australian Government has tasked the Bureau of Communications Research (**BCR**) with investigating and providing a report on options for the efficient and transparent funding of non-commercial services on the National Broadband Network (**NBN**). More specifically, the BCR has been asked to provide:

- advice on options to replace the current arrangement, where NBN Co funds non-commercial services through an internal cross-subsidy, with direct funding arrangements based on industry contributions; and

- recommendations on the total amount and possible structure of industry contribution arrangements.

In undertaking these tasks, the BCR is seeking input from the telecommunications industry and all other interested stakeholders, on the approach used to:

- quantify the losses from NBN non-commercial services, and

- develop transparent funding arrangements that support competitive market outcomes.

The BCR has issued a consultation paper entitled: *Bureau of Communications Research NBN non-commercial services funding options Consultation Paper* (**the Consultation Paper**). The Consultation Paper includes the BCR's detailed terms of reference (**the Terms of Reference**).[1]

iiNet is a carriage service provider and carrier[2]. iiNet is Australia's second largest DSL Internet Service Provider. iiNet employs more than 2000 staff across four countries and supports over 1.8 million broadband, telephony and Internet Protocol TV services nationwide. The broader iiNet Group owns networks that are used to provide superfast carriage services.[3]

The issues being explored by the BCR are of direct relevance to iiNet and its business. As such, iiNet welcomes the opportunity of responding to the Consultation Paper.

2. Structure of this submission

Although the Consultation Paper raises 28 specific and detailed questions, iiNet notes that the BCR is happy to accept submissions that do not address all of the specific questions raised.[4] In iiNet's view, there are two broad key issues that arise for consideration. These are:

- how to ensure that NBN Co's costs recovered through the levy are reasonable; and

[1] Appendix A of the Consultation Paper.
[2] The relevant carrier licence is held by Chime Communications Pty Ltd which is a subsidiary of iiNet Limited.
[3] These include VDSL 2 network in Canberra and HFC networks in regional Victoria.
[4] Consultation Paper, at p.33.

- how to ensure that the levy is targeted appropriately.

This submission provides iiNet's general views on these two key issues.

3. Ensuring that NBN Co's costs are reasonable

The cost standard

In its discussion of ‘costing’ non-commercial services, the BCR refers broadly to three methods of costing:[5]

- stand alone costs;
- marginal (or incremental) costs; and
- fully allocated costs.

While the first two types of costing are more economic in nature, the third approach is described as being 'commercially focused'.[6] In iiNet’s view, the ‘commercially focused’ framework suggested does not provide a strong economic basis for proceeding to estimate the costs of providing non-commercial services.

iiNet agrees with the BCR that the new arrangements should support improved contestability of fixed line service areas by funding the non-commercial services. However, the current proposed framework will not support competition on a level playing field basis as the BCR intends.[7] In particular, if the purpose of the costing approach is to promote contestability in both commercial and non-commercial areas, then the non-commercial services must be costed on an incremental or avoidable cost basis. Measuring costs using a fully allocated standard for uncommercial areas would give NBN Co a cost advantage in commercial areas. NBN Co need only recover the incremental costs of serving customers plus the remainder of common costs that are not recovered in non-commercial areas. In contrast, potential competitors would incur certain costs (e.g. network costs and corporate overheads) to serve the commercial area, plus pay a contribution to the same costs (e.g. corporate overheads) that NBN Co allocates to non-commercial areas.

In contrast, an approach that costs the obligation to supply services in non-commercial areas at incremental or avoidable costs means that competition in commercial areas occurs on the basis of the lower costs in the commercial areas. This is a true level playing field.

The rate at which costs and revenues are discounted

The BCR notes that the discount rate employed under a discounted cash flow analysis is an important input to determining financial outcomes. The BCR makes reference to a number of discount rates that ‘have historically been utilised to assess NBN commercial projections.’[8] The BCR also suggests it will determine a suitable discount rate for non-commercial services, rather than NBN Co as a whole.

[5] ibid, section 3.
[6] ibid, at p.13.
[7] ibid, at p.12.
[8] Ibid, at p.22.

iiNet notes that:

- The status of the discount rates listed in the Consultation Paper is unclear, with figures relating to the Telstra – NBN Co and Telstra – Government deals (which Telstra used), and which are not listed on a comparable basis.

- The rates listed omit NBN Co's rate used in its special access undertaking (**SAU**) – the risk free rate plus 350 basis points.[9]

- The BCR gives little indication why the cash flows for the non-commercial business will be different to the cash flows (and risks) accruing to NBN Co overall. If NBN Co remains the largest fixed line provider, then the two revenue streams will be closely linked.

iiNet suggests that the appropriate discount rate should be substantially lower than those quoted given record lows in long term risk free rates. For example, NBN Co's nominal vanilla WACC used in its SAU is only around 6 per cent.

Other points

iiNet makes four other points on the BCR's preliminary views on financial modelling and costing:

- Given that the nature of cross subsidy arrangements weakens efficiency incentives (as it is effectively a tax on competitors in commercial areas), NBN Co should be exposed to some risk to drive efficient investment and operating expenses in non-commercial areas. This might require use of forecasts rather than actuals in the financial model.

- There is no consideration of the advantages that NBN Co may accrue from being the provider in non-commercial areas. In other jurisdictions, these benefits are recognised as being important.

- It is unclear how the arrangements will work in the early periods when NBN Co may be the only supplier, and how costs will be annualised from the single NPV figure calculated from the modelling period.

- Using terminal values to quantify future losses at the end of the modelling period seems inappropriate if the suggested modelling period is long.

[9] See NBN Co Special Access Undertaking Final Decision 13 December 2013, at p.98 – available at: http://www.accc.gov.au/system/files/ACCC%20Final%20Decision%20on%20the%20Special%20Access%20Undertaking%20lodged%20by%20NBN%20Co%20on%2019%20November%202013.pdf

4. Ensuring the levy is targeted appropriately

iiNet is concerned that the BCR may have misapplied the Terms of Reference. In this regard iiNet notes the following statement in the Consultation Paper (emphasis added):[10]

> *Consistent with the Government's policy paper, the Terms of Reference ask that the BCR provide advice on direct funding arrangements based on **industry contributions from high-speed broadband access networks that target residential and small business customers**. **Any reference to alternative models that do not meet these requirements are included only for the sake of completeness and are not contemplated in this consultation paper.***

iiNet acknowledges that the Government's policy paper of December 2014 does refer to industry contributions from high-speed broadband access networks that target residential and small business customers.[11] However, in iiNet's view, any such comments in the Government's policy paper are subject to the Terms of Reference. This is clearly implicit by the following statement in the Government's policy paper (emphasis added):[12]

> *The Bureau of Communications Research (the policy research arm of the Department of Communications) will undertake an assessment of the costs of NBN Co's fixed wireless and satellite services, which serve many non-commercial parts of Australia, and provide options to Government for replacing the current opaque NBN Co cross-subsidy embedded in its wholesale access prices with more transparent funding arrangements. **Terms of reference for this assessment will be released early in 2015** with a view to having more transparent funding arrangements in place when the new regulatory framework set out in this paper commences (1 January 2017).*

This establishes that, as an independent body, the scope of the BCR's consideration should be determined by the Terms of Reference and not by the Government's policy paper. The Terms of Reference as relevant state (emphasis added):[13]

> *[…]*
>
> *The BCR will provide advice on options to replace the current arrangement, where NBN Co funds non-commercial services through an internal cross-subsidy, with direct funding arrangements based on **industry contributions**.*
>
> *The BCR will provide recommendations on the total amount **and possible structure of industry contribution arrangements**. In developing this advice the BCR will:*
>
> *2. Consider options for structuring the funding arrangements, including:*
>
> > *a. **options** for the efficient and transparent collection of **industry contributions***
> >
> > *b. **eligibility requirements of contributors** (based on revenue, services in operation or other criteria)*
> >
> > *[…]*

[10] Consultation Paper, at p.24.
[11] Australian Government Telecommunications Regulatory and Structural Reform December 2014, at p.6.
[12] ibid.
[13] Consultation Paper, at p.36.

3. *Consult with industry on the amount* ***<u>and possible structure of contribution arrangements</u>****.*

[…]

The Government's policy paper is not referred to at all in the Terms of Reference. iiNet respectfully submits that if the Government had wanted to limit the BCR to only considering a model were contributions are sourced from high-speed broadband access networks that target residential and small business customers rather than from industry more broadly, this would have been expressly stated in the Terms of Reference. The fact that the Terms of Reference refer only to 'industry contributions' clearly allows (and iiNet would say requires) the BCR to consider the merits of models that source contributions from the industry more broadly. Therefore, iiNet respectfully submits that the BCR should consider the merits of such models and should not proceed on the basis that it is bound to consider only a model that sources contributions from high-speed broadband access networks that target residential and small business customers.

iiNet notes that the BCR considers that industry funding eligibility should not include mobile broadband networks.[14] That is, only owners of alternative fixed high-speed broadband access networks would make contributions. iiNet makes two points on the BCR's initial views.

The first point is that for the purposes of creating a 'level playing field', all that is necessary is that NBN Co is able to make up its losses in non-commercial areas. These losses could be recovered in a number of ways, including through general taxation, broad industry contributions or 'narrow' contributions such as the approach referred to in the Government's policy paper. In contrast, the current USO funding can be characterised as a broader industry contribution because there are many industry contributors captured that do not directly compete with Telstra in providing basic fixed line services in non-USO areas. The USO levy applies to carriers broadly and includes carriers that provide mobile services, internet services and also carriers that provide services to large business customers.

The second point is that, as the BCR appears to recognise to some degree, a narrow funding base is likely to have a number of problems. For example, it could be distortionary, and raise issues of sustainability. That is because there are other kinds of similar services which will not be subject to the levy if a narrow funding base is adopted. iiNet wishes to emphasise that this distortion is not merely a function of 'technical' substitution but of 'commercial' substitution. The question is how consumers might trade off the potentially lower quality of other kinds of services (e.g. slower services delivered over fixed networks, or mobile networks) with the lower price of those networks. Significant distortions could then raise issues of sustainability. A further source of distortion may also then arise in the definition of networks that '*target residential and small business users*' – again the higher the contribution rate applied, the stronger the incentive will be to seek to avoid it.

In contrast, a broader industry contribution basis, such as that adopted by the USO, would be less likely to create distortions and be more sustainable. This is for two main reasons:

- The relative level of contribution (per line) in commercial areas will be lower, reducing the incentives to switch to other technologies that are not captured.

[14] Consultation Paper, at p.27.

- It would reduce the need to revise the arrangements over time, which creates risk to service providers which invest in large sunk assets which can only be recovered over long time periods. Changing the rules of the game after investments have been made is an undesirable practice likely to distort investment decisions.

In iiNet's view when considering a model based on 'industry contributions' the focus should be on the 'industry' and not on a narrow subset of the industry. Simply because NBN non commercial services can be narrowly categorised as being within the market for fixed line high speed broadband services for residential and small business customers does not mean that those services must be subsidised only from that narrow market. Adopting a narrow funding base based on a narrow market definition has the problems discussed above. It is also inconsistent with current regulatory practice in Australia relating to the USO[15] and many funding models overseas which require contributions from a broad range of industry participants.[16] If anything, having regard to the increasing trends towards bundling of services and increased convergence, iiNet submits that when the BCR is considering how to define the 'industry' for the purpose of establishing the cost base for the NBN non commercial services levy, the BCR should consider going beyond the USO approach. For example, content providers that will benefit from the rollout of the NBN could be included in the levy. Such an approach would be consistent with the principle of equity discussed in section 4 of the Consultation Paper (i.e. content providers will benefit from the rollout of the NBN so they should pay a contribution towards it). Such an approach would also be consistent with the definition of 'telecommunications industry' in the Telecommunications Act 1997 which includes an industry that involves supplying a content service using a listed carriage service.[17]

iiNet Limited
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[15] i.e. the funding base for the USO levy is not limited to networks that supply fixed line voice telephony services.
[16] iiNet notes that the BCR has considered funding models in various jurisdictions as referred to in Attachment C of the Consultation Paper.
[17] See section 7 of the Telecommunications Act 1997.