ECONOMUSE

The NBN and competitive neutrality

It looks like the NBN is out of bounds.

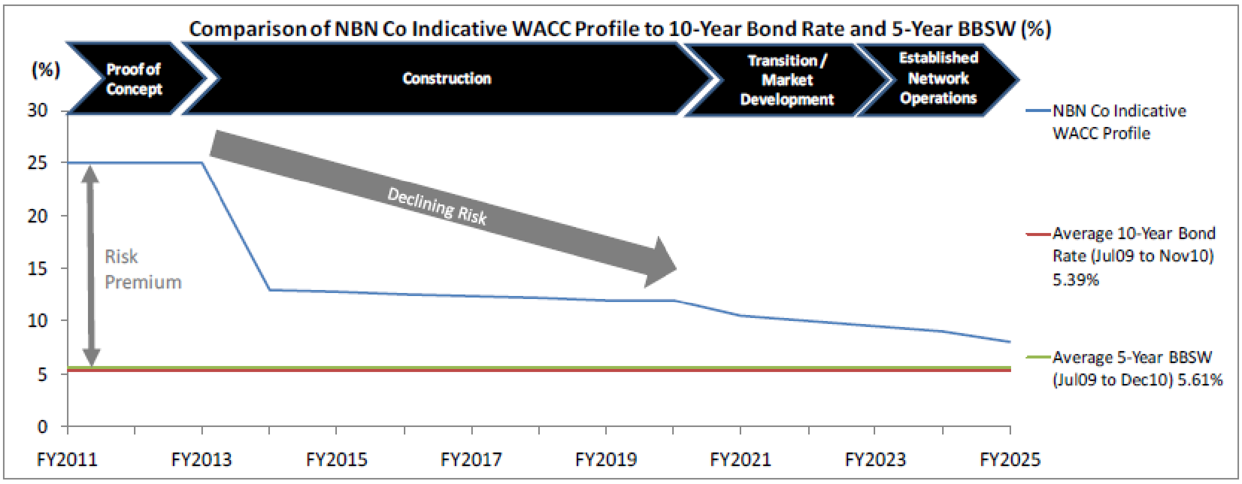
The NBN is supposed to promote competition. But, where it faces infrastructure competition (and that it going to become more frequent), it may be acting anti-competitively.

Normally, the discount rate applied to future cash flows is the weighted average cost of capital (WACC). But, this cannot be estimated for the NBN for various reasons. The answer is to set a rate that complies with competitive neutrality in order to neutralise an advantage of government ownership.

The *Competitive Neutrality Policy Statement* (1996) says that "*GBEs [government business enterprises] are specifically required to achieve, over time, as a minimum benchmark, economic rates of return on assets for their commercial operations equivalent to the long-term bond rate plus an appropriate margin for risk*". (p. 18)

The guidelines from 2004 say that when calculating a WACC is not feasible, broad-banding the risk premium is appropriate and suggests the three broad bands that range from 3% to 7% for low to high risk.

That is the approach that the ACCC used for the NBN SAU with a risk premium of 3.5%; which is a lower risk premium than the NBN would choose for itself; as this chart shows.



Source: NBN Corporate Plan, Dec 2010, p143

The NBN has already had a slap on the wrist from the guardian of the competitive neutrality principles. The Australian Government Competitive Neutrality Complaints Office (AGCNCO), a separate unit within the Productivity Commission, found in 2011 that NBN Co was in potential *ex ante* breach of competitive neutrality requirements.

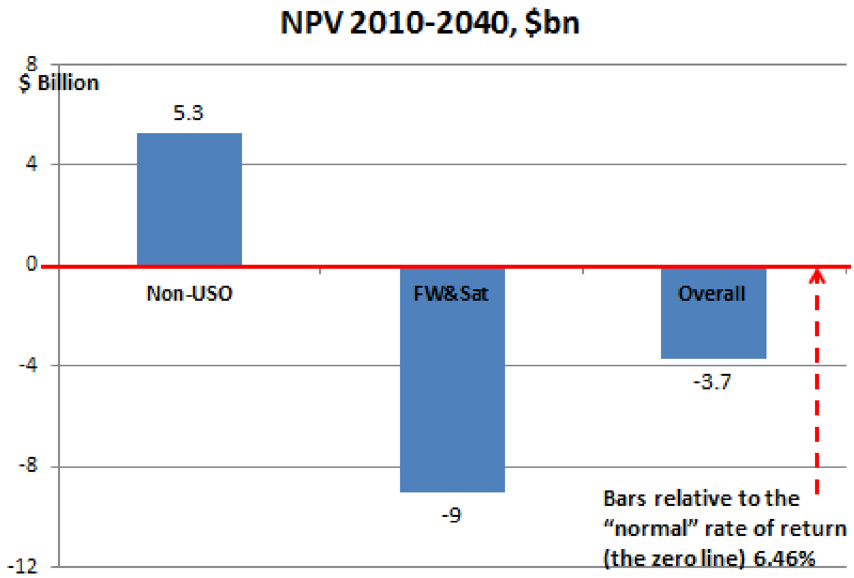
Some green-field fibre developers alleged that NBN Co's targeted (internal) rate of return of 7% and the timeframe over which it was expected to be achieved, represented a breach of competitive neutrality policy. The yield on 10 year bonds was then 5.4% so that the AGCNCO noted that the target 7% was *"below all risk broad-banding estimates of commercial rates of return".* But, it also noted that universal service objectives would depress the overall rate of return: *"In the absence of a quantification of the non-commercial benefits to be delivered by NBN Co, the targeted rate of return of NBN Co represents a* *potential ex ante breach of competitive neutrality policy".*

Guess what. That quantification has been done. So we can re-visit the competitive neutrality issue.

The Bureau of Communications Research (BCR) has estimated the net present value (NPV) of the NBN's non-commercial services (i.e. those provided over fixed wireless and satellite) as -$9 billion. The BCR followed the approach above with a discount rate of 6.46%; the 10 year bond yield was 2.93% to which a 3.5% risk premium was added.

The BCR and the ACCC seem happy with a risk premium for the NBN at the lower end of the 3-7% risk spectrum.

The NBN stopped providing long-term cash-flow forecasts years ago. So, we have to go the Strategic Review of December 2013 for such a projection (p107). Discounting the cash-flows by 6.46% gives an overall NPV of -$3.7 billion.



Sources: BCR, Strategic Review and Economuse

That means that the NPV of the NBN's commercial services is $5.3 billion. This is the 'super normal" profit (IRR must be above 6.46%) used to cross-subsidise non-commercial services. It is not enough that the IRR is above the benchmark rate for non-USO services: *"Competitive neutrality policy requires government businesses to set their prices such that they earn a commercial rate of return from their overall business activities"* (AGCNCO, 2011, emphasis added).

As noted, the internal cross-subsidy is not enough to fund non-commercial services so the rest is funded by a lower than commercial overall rate of return. The Strategic Review estimated an internal rate of return of 5.3% on the more optimistic revenue projections for the optimised multi-technology mix and just 3.1% on a pessimistic revenue scenario. Both are less than the benchmark commercial return used by the BCR.

The greenfield operators might have another shot at the NBN and maybe TPG might also like to test the NBN's competitive neutrality.

The BCR's proposed USO levy is unlikely to fix the problem. I have argued before that a major reason for poor profitability is that the NBN is priced below cost – not just for fixed wireless and satellite services.

A finding by the AGCNCO that the NBN is not complying with competitive neutrality principles would mean that the NBN has to increase its prices so that its overall rate of return reaches a commercial level.

That is a horrible prospect. The NBN may be priced below cost but it is already quite expensive and that will get worse as the over-hang in the Initial Cost Recovery Account (ICRA) is unwound.

Alternatively, the next government could to do an asset write down (which must, I think, be mirrored in a reduction of the ICRA) to get to the required rate of return. This will not affect the headline budget as write-downs are below-the-line (see Parliamentary Library note of January 2012). But, it may take another allegation against the NBN to force the required changes.

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