

ECONOMUSE

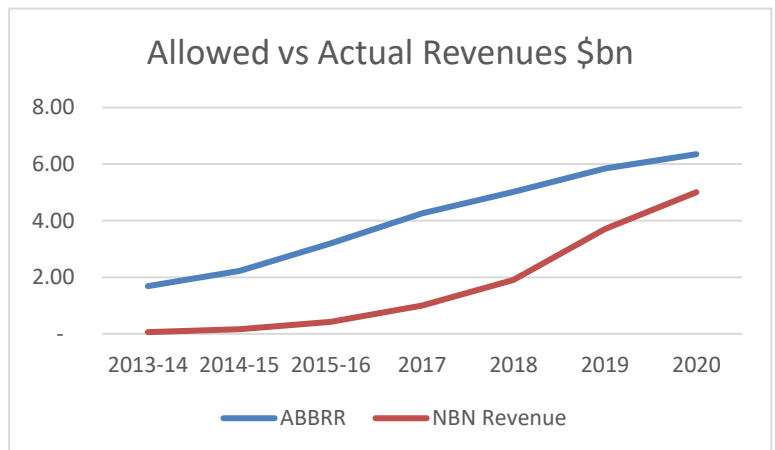
ARE NBN PRICES OUT OF CONTROL?

There is no effective regulatory constraint on soaring ARPU

My recent columns have looked at the structure of nbn prices. This looks at the current and future level of prices, which will affect the affordability, adoption and use of the NBN.

The blue line shows the annual building block revenue requirement (ABBRR) which is the revenue in each year that is allowed by the ACCC (my projection beyond 2016). In FY1026 the ACCC assumed a normal 6.5% return on assets which allowed revenue just over \$3bn compared with actual revenue that year (the red line) of under \$0.5bn.

We do not know when cash flows will turn positive but the current corporate plan forecasts an internal rate of return (IRR) between 3.2% and 3.7%; slightly up from the previous forecast but far less than the original expectation of 7.1% and the normal returns assumed by the ACCC.



To get that positive IRR, average revenue per user (ARPU) will have to increase: *“Even if we reach our planned 70%+ take up rate, nbn’s current revenue per user coming from the RSPs will not generate enough total revenue to produce a positive return on the investment made to build the network as it is planned”* ([Bill Morrow](#), nbn CEO, July 2017).

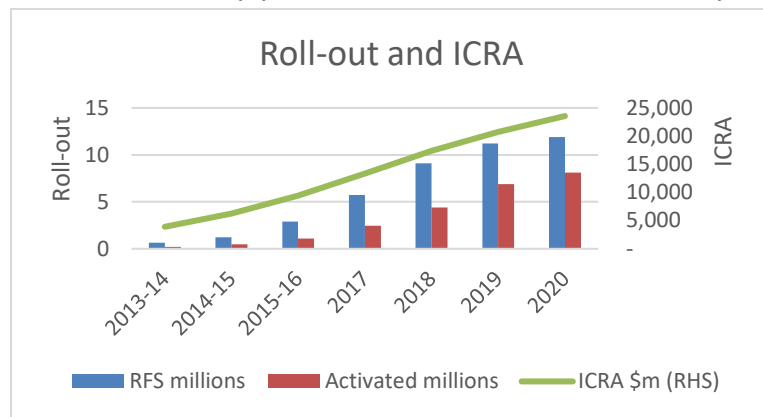
The nbn 2017 Corporate Plan says that it will grow ARPU from \$43 in 2016 to \$52 by 2020 (based on mid-year activated lines). That is a real increase of over 2% p.a. which is more optimistic than the 2013 Strategic Review’s long-term projections of declines up to 2.5% pa in residential ARPU.

Speeds	Prices	2017, %	2020, %	
12	\$24.00	30	18	
25	\$27.00	55	54	
50	\$34.00	5	10	
100	\$38.00	10	18	
Wtd. Average AVC		\$27.55	\$29.14	1.9% pa
ARPU		\$43.00	\$52.00	6.5% pa
Inferred CVC		\$15.45	\$22.86	14% pa

There are two constraints on nbn price levels: regulation and substitution from mobiles. The former is irrelevant. Initial prices could not be increased before June 2017. Now they can be increased by up to CPI-1.5% pa. As the Commonwealth assumes 2.5% for the CPI, that leaves a real increase of 1% pa.

But the nbn boasts rightly that it does not need to increase list prices. Nearly \$2 of the increase in ARPU will come from take-up of higher speeds. The rest comes from CVC revenues which increase with data volumes at over 30% pa unless discounts are increased. The CPI-x rule is irrelevant.

What is relevant is the gap between the revenue lines in the first chart because it provides a buffer before the regulated revenue envelope (the ABBRR) applies. That is, actual revenues can exceed the ABBRR in any year until the initial cost recovery account (ICRA) is extinguished (without



exceeding the CPI-1.5 rule due to data growth driving usage revenues). That buffer, the ICRA, will be over \$23bn by 2020 and [continue growing](#).

There should not be any buffer. It is normal to have losses in the early stages of any major roll-out which have to come before the customers and revenues. Shareholders will wear it when the net

present value (NPV) of cash flows is positive. Governments can accept lower returns.

What is not normal is to set prices below cost. A new network was always going to cost more than the copper network that it replaced. However, *“The initial prices were developed in consultation with access seekers so as to enable a smooth transition for end users from legacy networks to the NBN”* (NBN Co. letter to Optus, 14 January 2013) in accordance with government policy: *“The Government expects NBN Co.’s approach to pricing will recognise the importance of maintaining affordability to drive take-up rates”*, (Statement of Expectations, 17 December 2010). In this case the normal approach is to make grants *“to public enterprises to offset recurring losses, which are generated by a government policy to maintain prices at a level that does not cover the cost of production”* (ABS, p172 Cat. No. 51514.0). But such grants or subsidies would adversely affect the Commonwealth Budget (p11, [Parliamentary Library](#), Jan. 2012).

Neither the roll-out nor under-pricing call for an ICRA. In the 3 years to 2020 the gap between actual and allowed revenues is closing fast with annualised growth rates of 15% and 71% respectively. As noted above, the red and blue lines in the first chart can cross without any change in list prices because the nbn can let the growth in data drive CVC revenues.

This is not acceptable. In practice, the effective constraint on growth in nbn ARPU will come from the threat of mobiles taking a significant percentage of low use customers. Driving ARPU higher impacts both consumers and network owners who Ian Martin estimates have lost over \$22Bn in shareholder value – due mostly to margin compression. The situation is a mess. It needs fixing.

Ofcom has a [consultation](#) closing this month which sees 15% pa reductions in wholesale broadband access prices over the next 3 years to less than \$10 pm for 40/10 Mbps. Great for the UK. This is out of the question as nbn finances stand now but indicates how far Australia has strayed from the global norm.

Ian Martin (new street research note, 12 September 2017) can *“smell the mother of all regulatory backflips coming”* in the ACCC’s current review of the SAU. I absolutely agree that it is not the ACCC’s place to force a write-down – although a major [price restructuring](#) would be a major step forward and the ACCC can facilitate that.

John de Ridder