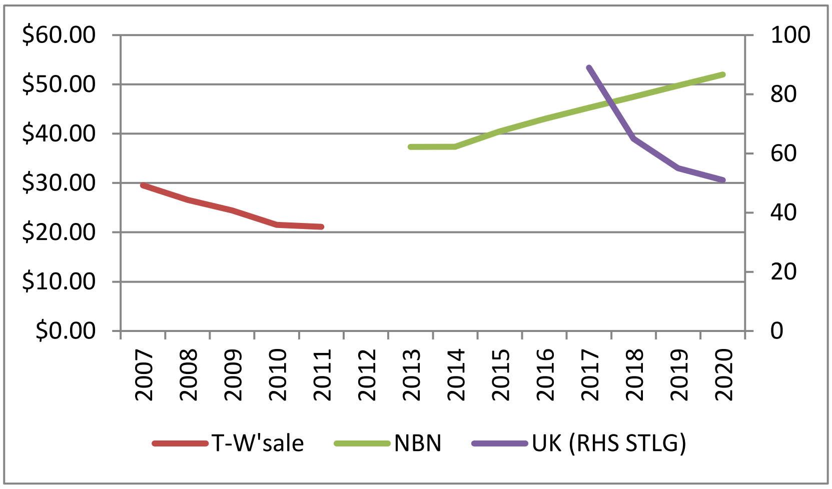
What is the fair value of the NBN?

We need a write down to stop the growth in wholesale ARPU

Historically in Australia and in another country in future (i.e. UK), wholesale average revenue per user (ARPU) falls (see chart). That trend has been reversed here because of the high cost of the NBN. Last week's column explained why the level of nbn's ARPU will rise. Below are some options to stop it.



Ditch the ICRA

This has to be part of any solution but achieves nothing within the next 3 years. The ACCC agreed to an initial cost recovery account (ICRA) so that the NBN could initially price below cost and recover accumulated losses in the future. Unless the Government instructs the ACCC to revoke the ICRA agreement, the nbn can collect at least $25 billion more than its regulated revenue (ABBRR) curve. If this was recouped over, say, 20 years on 8m lines, it averages an extra $13 pm per line.

Abolishing the ICRA would stop nbn revenues exceeding the regulated regulatory envelope. This has no immediate impact on the trend in ARPU or the Commonwealth Budget but it would make a big hole in nbn's long term business plan.

We can write down assets

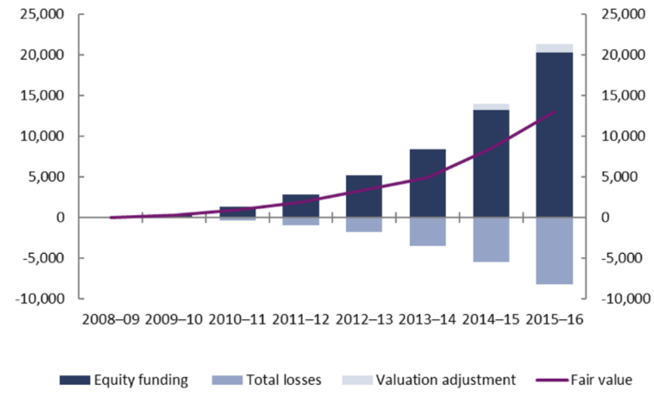
The corollary of putting a dent in expected revenues is an asset write-down to reflect changed expectations about future cash flows. This would have to happen even without revoking the ICRA as the Chairman of the nbn admitted this month that the company had under-estimated the growth in wireless capabilities.

Finance Minister Mathias Cormann claims that "*There is no basis for such a write-down. The government's investment in NBN can only be written down in accordance with the requirements of relevant accounting standards".* No problem.

The Department of Communications determines the "fair value" of the NBN according to the relevant accounting standards which say *"the objective of a fair value measurement in both cases is to estimate the price at which an orderly transaction to sell the asset or to transfer the liability would take place between market participants at the measurement date under current market conditions"* (Objective 2 of the AASB 13's Fair Value Measurement).

There is more than one way to do that. The Department uses the cost approach which deducts the present value of leave and superannuation liabilities from the estimated current replacement cost of property, plant and equipment to get fair value (see chart). The "valuation adjustment" is, I think, due to current cost accounting and resulted in a net <u>increase</u> (!) in nbn's value of $1.046 billion at 30 June 2016 with the net "*fair value*" of the NBN estimated at [$13 billion](#).

Figure 2–2: Fair value of NBN Co ($ million)



Other cost based approaches to the value of assets include the ACCC's building block (add investment and deduct depreciation to change the value of the regulated asset base over time) and the nbn's own annual report. As at June 2016, the ACCC valued the nbn's regulated asset base at $9 billion and the nbn [Annual Report](#) cites $18.5 billion ($24.1 billion at June 2017). These valuations are less than what the Commonwealth will have invested in the NBN: up to $29.5 billion in equity and up to another $19.5 billion in loans (which the [Parliamentary Budget Office](#) said might not be refinanced by the private sector).

You use a cost valuation technique when there is no better alternative and this is the case for government enterprises that do not generate significant non-government cash flows (e.g. the ABC, National Gallery and National Library). In the case of Australia Post, the Department uses the income approach which discounts future cash flows to determine net present value (NPV).

In its early life, the NBN's cash flows may have been so uncertain that the cost approach was warranted. That is not the case now. In 2016, Australia Post had revenues of $6.5bn with net cash flows of $0.4bn. For the nbn, revenue was $0.4bn (but $5bn by 2020) and it had a negative cash flow of $7.1bn (minus $2.5bn in 2020). Is it time to shift from the cost to income approach?

Exhibit 4-10: Calculation of IRR on Scenario 6

According to the Australian Accounting Standards Board (AASB), it is appropriate to change the valuation technique if the change results in a measurement that is equally or more representative of fair value in the circumstances. In my view, the fair value of the NBN should now be the NPV estimated from discounted cash flows, like Australia Post. What is the NPV of the NBN?

We need nbn to prepare a cash-flow forecast to 2040 that does not assume that past losses (i.e. the ICRA) can be recovered. It needs to identify the losses associated with fixed wireless and satellite services so that the IRR can be determined with and without (i.e. assumed subsidies) those losses and to estimate what write down would get the desired IRR. This will result in a lower trajectory for nbn ARPU that, hopefully, will allow it to provide affordable service in the long term.

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