Senate Standing Committee on Economics

ANSWERS TO QUESTIONS ON NOTICE

Treasury Portfolio

Budget Estimates

1 June – 3 June 2010

Question: BET 315

Topic: National Broadband Network Implementation Study

Hansard Page: Written

Senator EGGLESTON asked:

1. Is Treasury aware of recent commentary by Paul Kerin, Professorial Fellow, Melbourne Business School on the financial evaluation principles employed in preparation of the National Broadband Network Implementation Study?
2. Is Treasury aware that as identified by Mr Kerin, the Implementation Report appears to use the Government Bond Rate as the discount rate against which the project's internal rate of return is evaluated?
3. Is Treasury further aware that as stated by Mr Kerin, "the standard advice on discount rates provided by various government agencies -- the Finance Department, Infrastructure Australia, the Office of Best-Practice Regulation and the Productivity Commission -- warn against (using the Bond Rate in this way), as does the public economics literature. No mention is made of that standard advice, nor the literature, in the study's 546 pages. It completely disregards the government's own financial evaluation requirements."
4. In Treasury's view, is there any justification for exempting the NBN from the Government's standard financial evaluation requirements?
5. Does Treasury believe that it is appropriate to justify the business case for the NBN on the basis of what the Implementation Report describes as "government's low cost of funds"?
6. I again refer you to the Australian Government Competitive Neutrality Guidelines for Managers that discusses 'Debt Neutrality' as a key component of Competitive Neutrality. These guidelines state *"In circumstances where (a GBE is) able to borrow funds at a lower rate that your competitors (as a result of your government ownership), you will need to make adjustments to the cost of your debt. This is known as debt neutrality. Competitive Neutrality requires that the cost of debt to you is comparable to that of your private sector competitors. Competitive Neutrality does not require that your business borrow from the market at a full debt neutral rate. Rather, if you manage a significant business activity and are able to borrow funds at a lower rate than your competitors as a result of your government ownership, you must pay or notionally include a debt neutrality charge. The amount of any debt neutrality charge must be factored into pricing."* Is the Treasury aware that the Government's independent advisor on infrastructure projects, "Infrastructure Australia" has stated that the Government's access to low cost debt *"in no way removes the riskiness of the project"* and that *"project's cost of capital is not set by the cost of borrowing; it is the cost of bearing the project's risk"* and that as a result, Government

infrastructure projects *"should use the same discount rate as the private sector for assets of the same risk characteristics"*.

7. Has Treasury been asked to undertake any assessment of the cost to the Commonwealth of bearing the project risk of the NBN?
8. The only reason that NBN Co would be able to borrow at a lower rate than the private sector would be because of an explicit or implicit Government guarantee of its debt, is that correct?
9. In which case, the lower cost of NBN Co's debt would be subsidised by the fact that the Government would be taking on the risk of NBN Co being unable to repay its debts.
10. Isn't it true, that as Mr Kerin states *"an implicit guarantee doesn't make risk disappear, it just reduces debt-holders' risk and raises that of taxpayers"*. Wouldn't an implicit or explicit Government guarantee over the debt of NBN Co be a major risk to tax-payers?
11. Has Treasury been asked to undertake an assessment of whether NBN Co would be able to repay its debts during the life of the project?
12. Is Treasury aware that Mr Kerin has estimated the Net Present Value of the NBN by comparing the project Internal Rate of Return versus the weighted average cost of capital and equity internal rate of return versus the cost of equity using the data provided in the Implementation Report and has found that *"the government's equity investment in it are, in fact, hugely negative, even under the most optimistic scenario."* Is this finding of concern?
13. Isn't Mr Kerin correct when he states that the consequence of this 'hugely negative' Net Present Value of the NBN is that NBN CO "will not earn a commercial return and will require a multi-billion-dollar subsidy or bailout at some point"?
14. If NBN Co did proceed on the distorted financial basis advocated in the Implementation Report, what avenues of redress would disadvantaged commercial entities have? Would the Australian Government Competitive Neutrality Complaints Office be able to consider any complaint on this matter?
15. What remedies would be available to the Australian Government Competitive Neutrality Complaints Office?

Answer:

1. Is Treasury aware of recent commentary by Paul Kerin, Professorial Fellow, Melbourne Business School on the financial evaluation principles employed in preparation of the National Broadband Network Implementation Study?

Yes.

2. Is Treasury aware that as identified by Mr Kerin, the Implementation Report appears to use the Government Bond Rate as the discount rate against which the project's internal rate of return is evaluated?

3. Is Treasury further aware that as stated by Mr Kerin, "the standard advice on discount rates provided by various government agencies -- the Finance Department, Infrastructure Australia, the Office of Best-Practice Regulation and the Productivity Commission -- warn against (using the Bond Rate in this way), as does the public economics literature. No mention is made of that standard advice, nor the literature, in the study's 546 pages. It completely disregards the government's own financial evaluation requirements."

4. In Treasury's view, is there any justification for exempting the NBN from the Government's standard financial evaluation requirements?

5. Does Treasury believe that it is appropriate to justify the business case for the NBN on the basis of what the Implementation Report describes as "government's low cost of funds"?

The Implementation Study undertook a detailed financial analysis, including detailed revenue and cost modelling. This analysis indicates that under a range of realistic scenarios, the Government can expect to generate a rate of return on its equity investment sufficient to fully cover its cost of funds.

The Study confirms that the NBN business model would allow taxpayers to be paid back their investment, with a modest return, by year 15 of the project.

6. I again refer you to the Australian Government Competitive Neutrality Guidelines for Managers that discusses 'Debt Neutrality' as a key component of

Competitive Neutrality. These guidelines state "In circumstances where (a GBE is) able to borrow funds at a lower rate that your competitors (as a result of your government ownership), you will need to make adjustments to the cost of your debt. This is known as debt neutrality. Competitive Neutrality requires that the cost of debt to you is comparable to that of your private sector competitors. Competitive Neutrality does not require that your business borrow from the market at a full debt neutral rate. Rather, if you manage a significant business activity and are able to borrow funds at a lower rate than your competitors as a result of your government ownership, you must pay or notionally include a debt neutrality charge. The amount of any debt neutrality charge must be factored into pricing." Is the Treasury aware that the Government's independent advisor on infrastructure projects, "Infrastructure Australia" has stated that the Government's access to low cost debt "in no way removes the riskiness of the project" and that "project's cost of capital is not set by the cost of borrowing; it is the cost of bearing the project's risk" and that as a result, Government infrastructure projects "should use the same discount rate as the private sector for assets of the same risk characteristics".

Yes.

7. Has Treasury been asked to undertake any assessment of the cost to the Commonwealth of bearing the project risk of the NBN?

The Government commissioned the NBN Implementation Study to carry out an assessment of the project's likely implementation issues, including detailed revenue and cost modelling.

8. The only reason that NBN Co would be able to borrow at a lower rate than the private sector would be because of an explicit or implicit Government guarantee of its debt, is that correct?

9. In which case, the lower cost of NBN Co's debt would be subsidised by the fact that the Government would be taking on the risk of NBN Co being unable to repay its debts.

10. Isn't it true, that as Mr Kerin states "an implicit guarantee doesn't make risk disappear, it just reduces debt-holders' risk and raises that of taxpayers". Wouldn't an implicit or explicit Government guarantee over the debt of NBN Co be a major risk to tax-payers?

Recommendation 59 of the NBN Implementation Study states that NBN Co should be funded with Government equity until NBN Co can support private sector debt without explicit Government support and achieve an investment grade rating, and that private sector debt be permitted to be accessed to repay Government capital while maintaining an investment grade credit rating.

NBN Co, as a Government Business Enterprise, would be expected to access private sector debt on commercial terms, without the benefit of a government guarantee.

11. Has Treasury been asked to undertake an assessment of whether NBN Co would be able to repay its debts during the life of the project?

The Government commissioned the NBN Implementation Study to carry out a detailed assessment of the project's likely implementation issues. The Implementation Study indicates that under a range of realistic scenarios, the NBN would generate a rate of return sufficient to fully recover Government's cost of funds.

The Study also finds that, under its Funding Reference Scenario, NBN Co would have the capacity to raise private sector debt commencing in year 6 of the network rollout, and could commence making captial repayments to the Government in year 8 of the rollout, with $10 billion of the Government's equity returned by year 11 and $20 billion by year 15.

12. Is Treasury aware that Mr Kerin has estimated the Net Present Value of the NBN by comparing the project Internal Rate of Return versus the weighted average cost of capital and equity internal rate of return versus the cost of equity using the data provided in the Implementation Report and has found that "the

government's equity investment in it are, in fact, hugely negative, even under the most optimistic scenario." Is this finding of concern?

13. Isn't Mr Kerin correct when he states that the consequence of this 'hugely negative' Net Present Value of the NBN is that NBN CO "will not earn a commercial return and will require a multi-billion-dollar subsidy or bailout at some point"?

The Implementation Study team undertook a detailed financial analysis, including detailed revenue and cost modelling. This analysis indicates that under a range of realistic scenarios, the Government can expect to generate a rate of return on its equity investment sufficient to fully cover its cost of funds.

14. If NBN Co did proceed on the distorted financial basis advocated in the Implementation Report, what avenues of redress would disadvantaged commercial entities have? Would the Australian Government Competitive Neutrality Complaints Office be able to consider any complaint on this matter?

15. What remedies would be available to the Australian Government Competitive Neutrality Complaints Office?

The Australian Government Competitive Neutrality Complaints Office (AGCNCO) is an autonomous unit within the Productivity Commission. It was established by the Government under the *Productivity Commission Act 1998* to receive and investigate complaints about the implementation of competitive neutrality arrangements in relation to Commonwealth government businesses and business activities and to report to the Minister on its investigations.

Any individual or organisation (including a government body) may lodge a complaint with the AGCNCO. When the AGCNCO investigates a complaint, it provides a written report to the Government setting out its findings and the reasons for them. It subsequently publishes the report and also makes it available on this website. While the AGCNCO may recommend changes to competitive neutrality arrangements, the Government is not obliged to accept that advice.

The AGCNCO may recommend appropriate remedial action or that the Government hold a formal public inquiry into the matter. All adjustment payments are to be made to the Official Public Account.

The AGCNCO generally aims to report to the Government within 90 days of accepting a complaint. The Government generally aims to respond to recommendations within a further 90 days.