NBN FINANCING OPTIONS AND BORROWING AND BUDGET IMPACTS

Summary

I. Key points for the Government's announcement

1. In relation to the Government's financial commitment to the NBN initiative, the Government's announcement of the NBN should incorporate the following:

   - The Government will invest up to $43 billion to build and operate an NBN.
     - The Government intends to encourage private sector investment and the Implementation Study will examine how best to attract it. The quantum and timing of private contributions is unknown and unknowable at this time.
   - The Government's initial contribution to the NBN initiative will be up to $4.7 billion and this will cover start-up capital for NBN Co; a funding envelope of $500 million to achieve an early roll-out of a fibre to the home and premises network (supplemented by wireless and satellite services) in Tasmania; and a funding envelope of $250 million for a backhaul blackspots program.
     - In addition, to facilitate the NBN initiative (including the undertaking of the Implementation Study), the Government has agreed to the provision of $53.2 million over two years for the Department of Broadband, Communications and the Digital Economy and $1.05 million for the Department of Finance and Deregulation.
   - Further details will be made available in the 2009-10 Budget.

II. Matters to be settled in the 2009-10 Budget

2. Preliminary decisions about details concerning the timing and nature of Government contributions to the NBN initiative will be made in the 2009-10 Budget process, with further analysis to be undertaken in the Implementation Study and the results incorporated in the 2010-11 Budget.

3. The initial Government contributions and further equity and debt injections would be sourced from the Building Australia Fund (BAF) and additional Commonwealth borrowing.

   - The present plans for infrastructure spending in the 2009-10 Budget suggest that around $2.4 billion in cash from the BAF could be ear-marked for NBN Co. The remainder of the Commonwealth's contributions will need to be financed by borrowing, which could involve a combination of:
     - 'Aussie infrastructure bonds' marketed to retail investors, bearing in mind that this would need to be on more generous terms; and
     - additional CGS issuance, with both marketing and government financial reports identifying this portion of the Government's CGS program as specifically for the NBN; and
     - possibly, introduction of a long-dated infrastructure bond in the wholesale market (this would require further market advice on viability).

4. The Government's contributions to NBN Co's funding requirements should match as closely as possible NBN Co's actual expenditure profile, and the initial contributions (to be made over the forward estimates period) should be made predominantly via equity.

   - This approach appropriately reflects the start-up, capital intensive infrastructure business of NBN Co.

   - A preliminary view will be settled in the Budget but the most appropriate debt to equity ratio for NBN Co in the medium term will be examined in the Implementation Study and will also be subject to prevailing market conditions. The Board of NBN Co will also have a view and expect that this is taken into consideration.

5. The Government's contributions to the NBN should be built into the forward estimates in the current Budget process, with:

   - measure descriptions as set out in Attachment A, setting out those issues that will impact on the budget bottom-line, namely Departmental resourcing (including the cost of the Implementation Study);

     – Start-up capital for NBN Co, the Tasmanian program and the backhaul blackspots program will be capital transactions in the balance sheet.

       : Provision will be made in the Contingency Reserve for further equity and loan investments in NBN Co beyond the Government's initial $4.7 billion contribution.

     – an indicative profile for this funding will be settled between Finance, Treasury and DBCDE in the 2009-10 Budget process, and the profile then refined through the Implementation Study;

   - Allowance being made for a public debt interest cost associated with the borrowings necessary to underpin Government contributions to the NBN beyond the cash amount from the BAF (see below).

     – The public debt interest on the Government borrowings to fund the equity contribution could be in the order of $800-$900 million over the forward estimates period in total, assuming, among other things, no private sector equity contributions.

   - Estimating public debt interest costs will require a preliminary assessment of the profile of Government contributions to the NBN beyond the $4.7 billion over the forward estimates period, which will be settled by Finance, Treasury and DBCDE;

     – This would allow the Government to confirm that the estimates include a provision for the NBN Co, with the final level and structure of the majority of the capital contribution confirmed in the 2010-11 Budget following the completion of the Implementation Study.

III. Matters to be clarified during the Implementation Study

6. The ABS has not been consulted on budget classification issues specifically in relation to the NBN, however:

   - the ABS has provided preliminary advice that, if there is clear evidence of the objective and intent of a company in relation to operating in the market place and charging economically significant prices (as has formally been agreed by SPBC will be the approach for the NBN), this would enable the ABS to initially classify the entity in the PNFC sector.

     – if actual performance subsequently were found to differ from the original intent and objective, then the ABS may change its original classification.

   - in assessing whether contributions from the government to NBN Co should be classified as equity injections or grants (the latter impacting directly on the underlying cash balance), the ABS would consider the extent to which the Government retains a claim on the assets of the NBN.

     – The key characteristic of an equity injection is that the Government could reasonably expect to make a return on the capital. An allowance for a dividend holiday for a capital intensive start-up company is expected to be consistent with this approach.

7. Finance and Treasury will consult further with the ABS on the likely classification of NBN Co as a public non-financial corporation and its funding model in an iterative process after the Government's announcement, taking into account that the Implementation Study will generate the necessary information on the supporting business case.

8. The following further matters will need to be addressed in the Implementation Study:

   - The ability of NBN Co to borrow from the Government and directly from the market.

   - Whether NBN Co will require Government subsidies to sustain aspects of its operations. Any subsidies would have a direct impact on the underlying cash and fiscal balances of the budget, but it is not possible to determine the need for, or extent of, subsidies ahead of the more detailed study.

   - The implications of NBN Co's funding model for the Government's adherence with competitive neutrality commitments under COAG's Competition Principles Agreement.

NBN Co Funding Requirement and Profile

9. SPBC has agreed that if the Minister for Broadband, Communications and the Digital Economy terminates the NBN Request for Proposal (RFP) process, the Government would announce a commitment of up to $43 billion to build and operate an enhanced NBN, through the establishment of NBN Co. The initial advice to Government indicates a range for the cost of the NBN of $38 billion to $43 billion.

10. Based on these cost estimates, DBCDE has provided the following profile for the funding of NBN Co's (Table 1 below) based on a commitment of $43 billion. This estimate assumes the timing of the Government's contributions should reflect the expected timing of NBN Co expenditures and are based on the Government's intention of making early progress in both the NBN rollout in Tasmania and in addressing backhaul black spots.

11. The revised profiles suggest that initial contributions from the Commonwealth in 2009-10 of around $1.2 billion would be required, and that up to a further $18 billion would be required to the end of the forward estimates period (depending on the level of private sector involvement during the construction and build phase).

Table 1: DBCDE's indicative funding profile for NBN Co based on an indicative $43 billion commitment.

	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	Total
($b)	1.2	4.1	6.7	7.2	7.3	6.4	5.2	3.9	1.0	43.0

12. The profile in Table 1 is included in the paper for illustrative purposes only. The Working Group considers that it should not form the basis of detailed announcements about the quantum of funding to be provided by the Government to NBN Co in any particular year. In particular, the amounts identified for 2009-10 and 2010-11 appear quite 'aggressive', considering a range of factors including the work that needs to be undertaken in establishing NBN Co and that the results of the Implementation Study will not be available until early 2010. As indicated above, between the NBN announcement and the finalisation of the May 2009 Budget papers, Finance, Treasury and DBCDE would settle an indicative spending spread for inclusion in the Budget. The likely timing of NBN Co's expenditures will become much clearer once the Implementation Study is completed.

Proposed Financial Structure of NBN Co

13. It is proposed that NBN be established as a PNFC. To be a PNFC, NBN Co would need to be operating commercially charging economically significant prices. A commercial NBN Co could be funded through a combination of both debt and equity sourced from either the Government or the private sector. Two of the key issues to be resolved in assessing the funding of NBN Co include:

- what debt-equity ratio to adopt; and

- the timing of the respective contributions with an expectation that they will be predominantly equity up front.

14. The indicative modelling prepared by DBCDE of NBN Co is based on the company initially (that is, over the forward estimates period) being funded predominantly via equity injections (not loans) from the Commonwealth, with a medium term objective of a 50:50 debt equity ratio.

    - This structure is likely to mean that the ABS would classify the equity injections as a financing transaction (rather than as a grant) which would not impact on the underlying cash balance.

        – The key characteristic of a transaction that determines whether it is classified as a loan or as a grant/subsidy is the prospect of recoverability in the sense that the borrower would be able to service the loan. The more that an entity relies on Government funding, the more likely that a loan would be classified as a grant with a direct impact on the underlying cash balance.

    - The financial structure adopted in the indicative modelling also reflects the start up, capital intensive infrastructure business of NBN Co. In contrast to many state government sponsored PPP arrangements, there will be no guaranteed customer base, and market share and revenue to cover operating costs and service capital will need to be built over time.

        – The indicative break-even analysis by DBCDE assumes that initial Government contributions are equity, with debt funding introduced as cash flows permit — projected by DBCDE in its the analysis to be from year four of the nine year build.

        – The precise capital requirements of NBN Co, the funding profile, appropriate gearing and scope for private equity participation will need to be examined in detail during the Implementation Study, taking into account the timing and resilience of the revenue stream, operating costs and interest rates.

15. In assessing equity injections from the government, the ABS would consider the extent to which the Government retains a claim on the assets of the NBN. The key characteristic of an equity injection is that the Government could reasonably expect to make a return on the capital. It is reasonable to expect that the Government could make equity injections into a greenfields project such as the NBN on the basis of a prolonged dividend holiday.

<u>Funding of the Government's Equity Injections</u>

16. The Government equity injections could be funded from:

    - Cash reserves held in the BAF though the quantity would depend on the competing infrastructure demands on the BAF. At this stage, it is envisaged that around $2.4b could be financed from the BAF (i.e. the balance of the Communications Fund which has already been transferred to the BAF).

    - The remaining equity injections would be financed by additional Commonwealth borrowing. This borrowing could be through a combination of:

– 'Aussie infrastructure bonds' aimed at the retail market.

: Bonds targeted at the retail market would likely need to be offered on more generous and flexible terms than the CGS in order to make them attractive for retail ('mums and dads') investors.

: An alternative would be to develop a product tailored to individuals drawing on the advice of the AOFM;

– additional CGS issuance through the AOFM, with this portion of the Government's CGS program identified by the Government in both its marketing of the issuance and in budget and financial reporting as specifically for the NBN.

: Past experience suggests that the 'Aussie infrastructure bonds' are likely to generate from the retail market only limited amounts of funding relative to the capital requirements of the NBN. Additional CGS would be the most cost efficient way of raising the balance; and

– possibly, introduction of a long-dated infrastructure bond in the wholesale market (this would require further market advice on viability)

- Government borrowing – either through infrastructure bonds or through CGS – for the purpose of injecting equity into the NBN would increase the Government's net debt and gross debt but would have no impact on net financial worth.

  – The DBCDE analysis assumes no dividends would be paid on equity injections during the forward estimates, resulting in a negative impact on the underlying cash balance reflecting the cost of borrowing to finance the equity injections. The preliminary analysis by DBCDE suggests some initial returns on equity may be possible by Year 5, depending on take-up and the level of interest charges.

Options for NBN Co to raise Debt

17. Subject to the timing constraint discussed above, the NBN Co could borrow from the Government or from the private sector once it is in a position to service its debt from revenue generated by the sale of its products.

- The NBN Co could borrow from the Government. If these loans were advanced at the CGS interest rate this would represent concessional lending in the budget context, compared with a situation where the loans were offered at full commercial rates.

  – Concessional loans of this nature would have no net PDI costs and thus no impact on the underlying cash balance, nor any impact on net debt and net financial worth, but there would be an impact on the fiscal balance reflecting the value of the concession which is treated as a subsidy (and disclosed as a budget measure).

  – Additional issuance of CGS would impact on the Commonwealth's gross debt regardless of whether it is then lent to the NBN at commercial or concessional rates.

- Alternatively, the NBN could borrow at risk in the market either through contractual debt arrangements with financial intermediaries or through the issuance of bonds.
  - This approach would mean that the debt has no effect on the Government's gross or net debt but would be a significantly more expensive way to raise capital compared to additional CGS issuance;
    - Credit risk: the credit risk premium payable on contractual debt and bonds alike would reflect factors such as the greenfields nature of the project (particularly in its early years), the gearing ratio and uncertainty around cash flows. This premium could be expected to decline as greater certainty develops over revenue flows and the roll-out progresses.
    - Liquidity risk: should the NBN Co seek to issue bonds, then it would also pay a premium reflecting the liquidity risk associated with a relatively shallow pool of debt.
- The risk premium on the NBN Co's debt could be reduced through an explicit Government guarantee of its debt. However no decision on this issue need be taken until the NBN Co is expected to start borrowing during which time the financial markets may have recovered to the extent that such a guarantee is redundant.

Public Debt Interest

18. Table 2 shows preliminary estimates over the budget and forward estimates period for the public debt interest costs associated with the Government's borrowings to fund its contributions to the NBN initiative.

Table 2. Public debt interest - NBN

	2009-10	2010-11	2011-12	2012-13
PDI ($b)	0.0	0.06	0.25	0.55

Competitive neutrality

19. Under the Competition Principles Agreement (CPA), executed at the Council of Australian Governments' meeting in April 1995, the Commonwealth and all the States and Territories undertook to introduce several nation-wide reforms to competition policy, including implementation of competitive neutrality between government and private business activities.

20. Competitive neutrality policy requires that government business activities not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership. In essence, the Australian Government requires its businesses to: charge prices that fully reflect costs; pay, or include an allowance for, government taxes and charges such as Goods and Services tax, payroll tax, stamp duties and local government rates; pay commercial rates of interest on borrowings; generate

commercially acceptable profits; and comply with the same regulations that apply to private businesses (such as the Trade Practices Act and planning and environmental laws).

21. The requirement that government owned business entities should be subjected to similar borrowing costs to those faced by private sector businesses applies whether the entity raises finance directly in financial markets or borrows from the Budget.

- In the case of the former, it may be necessary to impose a borrowing levy should the cost of capital be less than that borne by the entity's competitors as a result of an implied Government guarantee.

- In the case of the latter, the entity would be required to pay a rate of interest to the Budget equivalent to what would be paid if the borrowing was occurring in the financial markets (without a Commonwealth guarantee).

22. Competitive neutrality requirements are not set down in legislation but a complaints process exists for those concerned by potential breaches of these policies. This is administered by the Australian Government Competitive Neutrality Complaints Office (AGCNCO), an autonomous unit within the Productivity Commission.

23. Any factors contribute to NBN Co obtaining debt finance on terms more favourable than could be obtained generally by a private sector entity in similar circumstances (eg, concessional loans, implicit or explicit Commonwealth guarantee), and which are not otherwise remedied, could lead to adverse findings with respect to compliance by the Government with its competitive neutrality policy. It is a matter for the Government as to how it responds to an adverse AGCNCO report.

Attachment A

Draft 2009-10 Budget Measures

Broadband Communications and the Digital Economy

National Broadband Network - investment

MEASURE INFORMATION

Capital ($m)

	2008-09	2009-10	2010-11	2011-12	2012-13	Code
Department of Broadband, Communications and Digital Economy	-	-	-	-	-	
Related expense						
- net public debt interest	-	[x.x]	[y.y]	[z.z	[z.z	

☐ Election commitment ☐ Treasury Tax Revenue measure

MEASURE DETAILS

The Government will invest up to $43 billion to build and operate a new National Broadband Network to deliver telephony and high speed broadband to Australian homes and businesses. The wholesale-only open access network will be based largely on fibre to the premises and will also include next generation wireless and satellite technologies. It will also include an interregional transmission fibre network offering backhaul services. Preliminary cost estimates are in the order of $38 billion to $43 billion, with detailed costing, engineering, commercial and structural requirements to be the subject of an implementation study to be completed by early 2010. The Government will establish [NBN Co] to build and operate the network and will commit an initial investment of up to $4.7 billion, including initial equity funding for NBN Co and related measures for Tasmania and broadband blackspots. The source and timing of remaining capital funding (in the form of further government or private equity and debt) will be determined following the implementation study. The initial equity investment is expected to be [$xxx.x] million in 2009-10, and [$yyyy] million in 2010-11. Additional commitments for the other elements of the proposal will bring the total commitments at this stage up to $4.7 billion.

[NBN Co] will be established as a company under corporations law and will operate as a government business enterprise. Private investment will be encouraged but ownership caps will be established to protect the Government's objective of a wholesale open access network. The Government intends to sell down its interest within five years after the network is built.

Given the commercial nature of [NBN Co], the investment will be reflected in the balance sheet of the Commonwealth General Government Sector as an equity investment

By investing in [NBN Co], the Government will be foregoing interest receipts or incurring interest costs on the amount it contributes as equity. This will have an impact on the underlying cash balance until the equity investment begins to pay sufficient offsetting dividends when the network is operating. This interest cost is reported above.

Provision has been made in the Contingency Reserve for further equity and loan investments to support the rollout of the new network ($xxxx million in 2010-11, $yyyy million in 2011-12 and $zzzz million in 2012-13). The precise amounts to be contributed by the Government will be determined following the detailed implementation study which will include the scope for private sector investments.

See also the related expense measures titled *National Broadband Network — implementation and establishment; National Broadband Network — early implementation of a network in Tasmania;* and *National Broadband Network — broadband blackspots* in the Broadband, Communications and the Digital Economy portfolio.

SUPPORTING INFORMATION

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National Broadband Network - implementation and establishment

MEASURE INFORMATION

Expense ($m)

	2008-09	2009-10	2010-11	2011-12	2012-13	Code
Department of Broadband, Communications and Digital Economy	9.9	43.3				
Department of Finance and Deregulation	0.2	0.9				

☐ Election commitment ☐ Treasury Tax Revenue measure

MEASURE DETAILS

The Government will provide $53.2 million in 2008-09 and 2009-10 to the Department of Broadband, Communications and the Digital Economy to conduct an implementation study for the National Broadband Network that will examine detailed costing, engineering, commercial and structural issues and report by early 2010. The funding will also support the Department in the early implementation of a network in Tasmania, in implementing the priority broadband blackspots initiative and in developing legislation and a regulatory framework. The Government will also provide $0.2 million in 2008-09 and $0.9 million in 2009-10 to the Department of Finance and Deregulation to assist in the implementation and establishment stage, in view of Finance's role advising its Minister as joint shareholder of [NBN Co].

See also the related expense measures titled *National Broadband Network — investment; National Broadband Network — early implementation of a network in Tasmania;* and *National Broadband Network — broadband blackspots* in the Broadband, Communications and the Digital Economy portfolio.

SUPPORTING INFORMATION

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National Broadband Network - early implementation of a network in Tasmania

MEASURE INFORMATION

Capital ($m)

	2008-09	2009-10	2010-11	2011-12	2012-13	Code
Department of Broadband, Communications and Digital Economy	-	-	-	-	-	

☐ Election commitment ☐ Treasury Tax Revenue measure

MEASURE DETAILS

The Government will provide up to [$500] million over four years to Tasmania to implement an early roll out of a mainly fibre based network in the state. The investment will be in the form of a loan [details to be confirmed] to Tasmania which is not expected to have a direct impact on the underlying cash or fiscal balances. The loan will be reflected as an investment in the balance sheet of the Commonwealth General Government Sector.

The early investment in Tasmania will bring the benefits of widely available broadband sooner than otherwise to the homes and businesses of the state. The network [may/will] later form part of the National Broadband Network and the experience in Tasmania will assist the roll out of broadband elsewhere in Australia.

See also the related expense measures titled *National Broadband Network — investment; National Broadband Network — Implementation and Establishment;* and *National Broadband Network — broadband blackspots* in the Broadband, Communications and the Digital Economy portfolio.

SUPPORTING INFORMATION

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National Broadband Network — broadband blackspots

MEASURE INFORMATION

Capital ($m)

	2008-09	2009-10	2010-11	2011-12	2012-13	Code
Department of Broadband, Communications and Digital Economy	-	[250.0]	[x.x]	-	-	

☐ Election commitment ☐ Treasury Tax Revenue measure

MEASURE DETAILS

The Government will provide [$250.0] million in 2009-10 [and $x.x million in 2010-11] [spend spread for the $250 million to be settled] to address priority broadband blackspots in advance of implementation of the National Broadband Network.

The funding will be used to provide fibre optic transmission links to remove blackspots in the backhaul network, to be identified in consultation with industry. These links will later form part of the National Broadband Network.

See also the related expense measures titled *National Broadband Network — investment; National Broadband Network — Implementation and Establishment;* and *National Broadband Network — early implementation of a network in Tasmania* in the Broadband, Communications and the Digital Economy portfolio.

SUPPORTING INFORMATION

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