

NBN Co's Status as a Public Non-Financial Corporation

Background

- The Government has announced that the National Broadband Network (NBN) will be built by a company established for that purpose (NBN Co), in partnership with the private sector.

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- NBN Co is currently classified as a Public Non-Financial Corporation (PNFC) by the Australian Bureau of Statistics (ABS)

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As a result, it is considered to act independently of government for budget accounting purposes. Funding may be provided to NBN Co as equity injections (in exchange for shares) which do not have a Budget impact.

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If NBN Co loses its PNFC status, any funding provided to NBN Co for building the NBN will have a negative Budget impact.

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- Classification as a PNFC

- PNFC status is determined by the ABS and can be reviewed over time as circumstances change. Under the Standard Economic Sector Classifications of Australia (SESCA) published by the ABS, Government owned corporations and notional institutional units engaged in market production are excluded from the General Government Sector (GGS) and are instead classified as PNFCs (or Financial Corporations if they provide financial services).
- A PNFC is defined as a resident non-financial corporation or quasi-corporation that is controlled by a unit of the GGS. A Non-financial corporation is a corporation or quasi-corporation that is mainly engaged in market production of goods and/or services other than financial intermediation or auxiliary financial services¹.
- The main function of PNFCs is to provide goods and services which are predominantly market, non-regulatory and non-financial in nature, and mostly financed through sales to consumers.
- Enterprises in the PNFC sector differ from those in the GGS² in that all or most of their production costs are recovered from consumers, rather than

¹ Standard Economic Sector Classifications of Australia (SESCA), 2002, Glossary

² By contrast, the general government sector comprises all government units of the Commonwealth Government, each state and territory government, each local government authority, and all resident non-market NPIs that are controlled and mainly financed by those governments. Included in the

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being financed from the general taxation revenue of government. Some enterprises, however, do receive subsidies to make up for shortfalls incurred as a result of government policy, for example, in the provision of 'community service obligations' at concessional rates³.

- In briefing Finance in relation to the NBN, the ABS advised that NBN Co would be likely to be classified as a PNFC if the company:
 - operated in a market place;
 - charged economically significant prices; and
 - did not require substantial ongoing subsidies to support its operations.

Operated in a market place

- Market operators are units which respond to market forces⁴. Market operators make decisions about what to produce and how much to produce in response to expected levels of demand and expected costs of supply and are exposed to the risks associated with this production. Market operators adjust supply either with the goal of making a profit in the long run or, at a minimum, covering capital and other costs.
- A market operator is identified through a range of attributes. A primary indicator is the expectation of the recovery of a considerable proportion of its production costs through sales income. Conversely, non-market operators are not likely to respond to changes in economic conditions in the same way as market operators. Their economic behaviour is influenced by the receipt of material financial support in the form of transfers such as grants and donations.
 - *NBN Co has been established as a separate company with a Board that has day-to-day responsibility for running the company on a commercial basis independent of Government.*
 - *If NBN Co can achieve a internal rate of return above or at the bond rate in the medium-long term, it will satisfy this test.*
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sector are government-controlled unincorporated enterprises that engage in market production but do not qualify as quasi-corporations because their operations are too closely integrated with the operations of other government units and are not the subject of a separate full set of accounts.

³ Government Finance Statistics, Australia, 2005-06, Explanatory Notes, para 10

⁴ Standard Economic Sector Classifications of Australia, 2008, ABS at p24

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Economically significant prices

- Prices are said to be economically significant when they have a significant influence on the amounts the producers are willing to supply and on the amounts purchasers wish to buy (sometimes called 'market prices')⁵.
 - *If the price of NBN Co's services is determined by the market it will satisfy this test.*
 - *If prices are set at a uniform level, this test will still be satisfied if prices are set above or close to market prices ie not at heavily subsidised or nominal levels. Clarification from ABS is required.*

No substantial ongoing subsidies to support operations

- Finance's view is that this does not mean that subsidies cannot be provided to NBN Co, particularly in relation to any universal service obligations that may be imposed. The ABS has previously advised Finance that subsidies for the entity could be up to 50% of revenue, noting that subsidies paid to NBN Co will have an impact on the Budget bottom line which may not be acceptable to Government.
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- *Note: The test is not an absolute one – it is not the case that if an entity gets to 51% it qualifies but if it only gets to 49% it fails – the ABS consider the proportion as a general principle to apply in conjunction with other factors such as the business model adopted and focus on a profit objective. There are some examples in Australia where entities are classed as PNFCs with a lower percentage revenue than 50%, although these are almost exclusively in the public transport business.*
- *If NBN Co is able to recover the majority of its operating costs through ongoing revenue it will satisfy this test.*
- *NBN Co may need a substantial upfront grant to build the network. Further consideration will need to be made to determine the implications such a grant will have on NBN Co's PNFC status.*

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Equity injections

- In assessing whether contributions from the Government to NBN Co will be classified as equity injections or grants, the key characteristic of an equity injection is whether the Government will retain a claim on the assets of NBN

⁵ UN Statistics Division, <http://unstats.un.org/unsd/sna1993/glossform.asp?getitem=129>;
ABS, Australian Economic Indicators Glossary

Co: in substance, the Government should reasonably expect to recover the investment at some time in the future.

- More specifically, in order for contributions to be classified as equity injections in substance, NBN Co would need to expect to recover the entire principal (in real terms). The higher the recovery above this level, the more likely ABS/ANAO would treat the funding as equity.
 - *If NBN Co is likely to achieve a rate of return in the long term that will support an eventual sale of the company, contributions may be classified as equity injections.*

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- If an initial business case supports equity treatment, there will remain an ongoing risk of ABS re-classifying NBN Co as part of the GGS if the mature business no longer meets expectation of recovery of equity.

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- [Can FMG please provide any further clarity on the definition of an equity injections compared to a grant]. The definitions of equity are set out in accounting standards and the GFS Manual. In essence, they mean that the equityholder retains a claim on the net assets of the investee, which it can later sell, redeem or transfer; and has a right to income distributions (dividends or similar). In assessing new policy proposals for budget impact, Finance consider the substance of the arrangement rather than the legal form, and require that there is both the intent and the capacity for the government to get its money back by selling, redeeming or transferring its interest, or by earning dividends. Conceptually, it is not appropriate to classify funding as equity if there is no intent or no hope of the government recouping its investment – this would be in substance a grant.

- For this purpose, the government looks to a return of its original principal in real terms. s47C

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- A proposal could be classified as partly equity and partly grant if it does not meet the test to be fully classified as equity.

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Way forward

- Finance proposes to engage with ABS shortly in relation to NBN Co's PNFC status to obtain further information on the process that will be undertaken and the information that will be required to determine NBN Co's classification.

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- We will seek confirmation of NBN Co's PNFC status once NBN Co has formulated the initial draft of its business case in early 2010. We understand the ABS will require, at a minimum, a detailed business case (including forecasts of revenue, ongoing capital and operating expenses and details of the proposed capital structure) to be able to assess whether PNFC status is appropriate.

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- Until the ABS has provided its consideration at that time, the risk remains that NBN Co may not be classified as a PNFC entity and its funding will have a Budget impact.

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