BT's response to Ofcom's consultation document

"Recovering the costs of investment in network expansion"

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NON-CONFIDENTIAL VERSION

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Contents

1 Introduction and executive summary

1.1 BT has made a voluntary offer to Government to ensure every premise in the UK has access to a broadband service capable of delivering a minimum of 10Mb/s by the end of 2020. BT has made this offer because we share Government's view that broadband plays an increasingly important role in people's lives, and we believe that a universally available safety net will ensure that no one gets left behind.

1.2 BT is the UK's biggest investor in broadband infrastructure through Openreach (a functionally separate line of business within BT plc). Openreach is extending faster broadband services by undertaking both commercial investment, as well as investment with public bodies and communities.

1.3 The offer made by BT to Government is based on a proactive network build model – i.e. the necessary infrastructure to connect the majority of households and businesses would be built proactively rather than waiting for a request.

1.4 The model uses a range of technologies to get to the hardest to reach parts of the UK. Fixed technologies (including fibre to the cabinet and fibre to the home) will take the 10 Mb/s coverage to 99% of the country by 2020. Fixed wireless on demand and satellite will be used in the remainder of the country. The cost recovery mechanism proposed by Ofcom relates only to the former.

1.5 We consider that a commercial solution is preferable to a USO (the proposed "New Broadband Service Obligation") on which DCMS is consulting separately.[1] We have concerns that a USO, as currently outlined, could be inefficient and slow to implement, resulting in higher costs and long lead times for customers. In contrast, our offer would enable customers to enjoy faster speeds, at a lower cost, far sooner.

1.6 BT would fund the investment required to deliver the commitment. Ofcom is consulting on how the efficiently incurred costs would be recovered through Openreach charges for products which provide access to its local access network (of which the fixed broadband elements of this network enhancement would form a part).[2]

1.7 This is a sensible and pragmatic cost recovery solution given the benefits to all of Openreach's customers that the (open access) network enhancement will provide. Moreover, the services provided over the enhanced network will fall within the wholesale local access market, and much of the investment will occur within the forthcoming review period (commencing 1 April 2018).

1.8 Openreach's response to Ofcom covers the detail of the proposed cost recovery mechanism consistent with it having delivery responsibility for the proposed network deployment, and the costs being recovered though its regulated broadband products. This response sets out BT Group's perspective as sole investor in the universal broadband offer, and as a downstream customer of Openreach who will be able (like other Communication Providers) to offer enhanced services to beneficiaries of the investment.

1.9 As investor, BT is concerned that the cost recovery mechanism provides a reasonable degree of certainty that BT will have the opportunity to recover its efficiently incurred costs (including a fair return) both in the forthcoming review period and subsequent review periods given the proposed spreading of capital costs. As a customer of Openreach, BT is eager for the benefits

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[1] BT is responding to this consultation, as is Openreach.

[2] The costs relating to fixed wireless and satellite are not considered to be relevant for the charge controls.

of the network enhancement to be available as soon as possible to enable enhanced services to be offered (in competition with others).

1.10 The response is structured as follows:

- Section 2 provides BT's comments on the proposed cost recovery mechanism as investor in the proposed network enhancement, in particular, the degree of certainty provided by Ofcom that efficiently incurred costs spanning review periods will be recovered using a consistent and transparent recovery mechanism. This section also highlights the importance of allowing an appropriate return which reflects the systematic risks associated with the network enhancement.

- Section 3 outlines the views of BT's downstream businesses on the network enhancement that would be delivered by Openreach should Government agree to BT's offer and the proposed cost recovery mechanism.

2 Recovering the efficient costs of network enhancement

Introduction

2.1 As the investor in the network enhancement that will support the delivery of BT's universal broadband commitment, BT welcomes the sensible and pragmatic cost recovery mechanism proposed by Ofcom. More specifically:

- *We agree that it is appropriate to recover the costs of the network enhancement through Openreach's wholesale local access (WLA) products*. In order to fulfil the commitment to reach 99% coverage, Openreach will incur costs relevant to the WLA charge controls and commence service provision in the period covered by Ofcom's market review proposals.[3] It is entirely consistent that the expansion of the access network should be included in the aggregate costs of providing the associated wholesale services.

- *We agree that it is appropriate to spread the cost of the network enhancement across all wholesale broadband lines supplied by Openreach in the WLA market nationwide*. We agree that Ofcom should avoid unduly distorting price signals by loading costs onto fibre lines. We also agree that it is appropriate to seek to minimise the mark up that any single customer faces. The benefits (to all customers) of achieving greater social inclusion are also relevant, and further support recovery across a wide base.

- *The mechanism proposed by Ofcom provides sufficient incentives for cost minimisation*. In particular, the charge controls in question are specified by reference to CPI-X allowing Openreach to keep the benefit (for a period of time) if it exceeds efficiency targets (e.g. by delivering greater cost efficiency than expected). We also understand that Ofcom (and Cartesian) have modelled the efficient costs of a network that is capable of delivering the service specification in our proposal.

2.2 As regards the details of the cost recovery mechanism and Ofcom's modelling approach we support the submission of Openreach on these issues. In particular, whilst the overall results appear to be reasonable, the methodology could be refined to deliver more robust estimates.

2.3 For those parameters that are inevitably uncertain (e.g. the number of eligible premises) we consider that an Open Market Review is necessary to allow a robust estimate to be established which reflects the various public and private schemes that will affect this parameter going forward. We (and Openreach) have provided a best estimate which reflects our planned deployments and the roll-out plans of other network providers[4], but an industry-wide assessment led by Government may be more accurate.

2.4 The remainder of this section addresses the issues which are particularly important to BT, as investor, namely:

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[3] Those costs which are not relevant to the charge controls (i.e. those relating to fixed wireless and satellite solutions) will not be included.

[4] Based on public domain information.

- ensuring an appropriate commitment by Ofcom to cost recovery which will happen in subsequent review periods, in relation to which, Ofcom retains discretion on how to set charges; and

- ensuring that project specific risks are appropriately reflected when setting a return that Openreach will be permitted to earn in respect of this investment.

Cost recovery over future review periods

2.5 The vast majority of costs [✂] will be recovered in review periods after the three year period due to commence on 1 April 2018 (i.e. in the review periods commencing 1 April 2021 and 1 April 2024, assuming the continuation of three year review periods).

2.6 This is due to the long lived nature of some of the assets to be used in the network expansion, and Ofcom's proposed depreciation policy which spreads the capital costs (revised for asset price changes) over the life of the asset on a straight line basis.

2.7 In contrast, the vast majority [✂] of capital costs will be incurred in the forthcoming review period – i.e. between 2018 and 2021. We are, therefore, exposed to a potential change in regulatory approach after the costs have been incurred.

2.8 Without a regulatory asset base acting as a commitment device (as typically occurs for significant capital projects in other regulated sectors) we are reliant on Ofcom providing a commitment in other ways. If this is insufficient, there is a risk that we are disproportionately exposed to the risk of regulatory failure.

2.9 Ofcom has dealt with this issue by stating that costs incurred in the delivery of our universal broadband offer would be treated consistently with the approach taken to Openreach's costs in general in future reviews. Ofcom also models cost recovery over an extended period (to 2028/29) in order to provide some transparency on the impact on prices going forward (although there is no commitment that Ofcom would be bound by this in subsequent reviews). More specifically:

- Ofcom states that "*Although we will only be able to determine our precise approach to future charge controls at the time of setting them, we anticipate that we would treat the costs incurred in this particular network expansion consistently with the approach we use in the next charge control relating to BT's costs in general, and consistent with our principle of allowing the expectation of the recovery of efficiently incurred costs*."[5]

- As regards its modelling, Ofcom states that "*extending the study period to 2028/29 would provide further transparency to all stakeholders as to the impact of our proposed approach on future WLA prices should these costs be included in future price reviews*."[6]

2.10 Although these statements are designed to provide reassurance, and to guide our expectations, it is clear (from the sections underlined) that Ofcom cannot fetter its discretion. It leaves open both: (i) whether the costs are to be included in future price reviews (through use of the word "should" in the second statement); and (ii) the precise approach Ofcom will

[5] Para 5.4.

[6] Para 5.27.

take to cost recovery in future reviews. These caveats (particularly the first) are not consistent with the "*principle of allowing the expectation of the recovery of efficiently incurred costs*".

2.11 We ask, therefore, for a clearer commitment by Ofcom that current and future charge controls will provide Openreach with an opportunity to recover its efficiently incurred costs. More specifically, an unambiguous statement is needed that Openreach can have the legitimate expectation of full recovery of the efficient long run incremental costs of network expansion over the lifetime of the investment (where the lifetime is a function of Ofcom's approach to depreciation).

2.12 In subsequent reviews, Ofcom might consider a more formal commitment mechanism for this network enhancement – i.e. specifying a regulatory asset base, which provides much greater clarity on the recovery of invested capital including an appropriate rate of return.

2.13 At the very least, Ofcom should clearly indicate that, if the assets created through this network enhancement are subsumed in subsequent reviews within a broader bottom up model of the fibre network, Ofcom will commit to ensuring neutrality in the cost recovery impact.

2.14 Put simply, our opportunity to recover our efficiently incurred costs should not be adversely affected by a change in modelling approach. Ofcom should pre-commit to this, and indicate how it will be achieved (i.e. how the relevant costs will be identified within a broader model to ensure consistent treatment over time).[7]

2.15 Without this, we are concerned that investor expectations will not be sufficiently underpinned, and that perceptions of the risk of this investment will be greater than they might be with a clearer commitment device (i.e. there would be a regulatory failure).

Recognising risks to investors

2.16 Ofcom rightly recognises that the cost recovery mechanism must include an appropriate return on capital employed in the network. Ofcom proposes to use the Openreach access line WACC (estimated by Ofcom at 8.0% pre-tax nominal in the March 2017 WLA Consultation)[8] on the basis that systematic risks for the investment are akin to access lines in general.

2.17 In reaching this view, Ofcom points to the effect of the proposed cost recovery mechanism itself in reducing demand risk (i.e. by allowing Openreach to recover the costs across all Openreach broadband lines, regardless of whether they are copper or fibre based, rather than from direct beneficiaries only).

2.18 Whilst it is the case that the mechanism proposed by Ofcom helps to reduce risk in certain respects, Ofcom should consider further how the systematic risks for this network enhancement will differ from the systematic risks for access lines in general. In particular, there are distinguishing features in relation to the following risks:

- *higher capital leverage* – Ofcom acknowledges that high capital leverage can give rise to higher systematic risk (because the volatility of returns are magnified) and that, with investment mostly occurring before 2021, the project will have higher capital leverage initially. Importantly, the systematic risk will be higher than for the legacy access network (which underpins the 8.0% estimate) because costs – largely

[7] Any circumstances in which Ofcom would consider a change in approach for the recovery of these committed costs to be reasonable and appropriate should be set out expressly in the final statement.

[8] Openreach has submitted evidence in the context of the WLA consultation supporting the view that a more appropriate estimate of the Openreach access line WACC would be 8.5% pre-tax, nominal.

maintenance – relevant to these legacy assets are more stable relative to associated revenues (i.e. they do not give rise to comparable capital leverage risks). Ofcom comments that the capex involved in the network deployment is low compared to the overall opex and capex associated with the base of lines from which it is proposed to be recovered. The relative size of the cost base, however, is not relevant to the question of how costs compare to associated revenue streams (i.e. leverage) which will be higher in the early years of the project and which will differ, in this respect, from the legacy asset base.

- *long term payoffs* – a higher WACC is also justified where the investment is exposed to longer term payoffs (and the associated risks) than the legacy assets. This is the case because the legacy assets are partially depreciated, whereas the new assets are not and will be recovered over longer timescale (reflecting the economic life of the underlying assets which includes new duct). Over the longer term there is uncertainty as to how rival networks may develop (including mobile) and therefore the extent to which it will remain possible to recover costs through regulated prices. The partially depreciated legacy assets will be recovered sooner, and are not, therefore, exposed to these longer term risks to the same extent.

2.19 On this basis, we consider that Ofcom has under-estimated the appropriate return that should be allowed as part of the cost recovery mechanism and that a WACC higher than 8% (pre-tax, nominal) is justified.

3 Perspective of BT businesses downstream of Openreach

3.1 The businesses downstream of Openreach support, in principle, a solution that ensures that all UK premises have access to faster broadband services even in the hardest to reach parts of the UK.

3.2 If accepted by Government, the proposed network deployment will allow the businesses downstream of Openreach to compete for the supply of enhanced services to the beneficiaries of the investment.

3.3 We would expect our rivals to support the proposal for similar reasons – i.e. the early opportunity it creates to compete more effectively for customers in every part of the UK with differentiated broadband (and bundled) propositions.

3.4 The solution proposed by BT (together with the cost recovery mechanism proposed by Ofcom) has the advantage that BT's downstream businesses can start competing with enhanced services and propositions sooner than might be the case with alternative solutions.

3.5 We also consider that customers will have a better service experience with a proactive and planned build model (i.e. the proposed roll out of fixed technologies to 99% of the country) because they are likely to get enhanced services sooner than for entirely "on demand" models, or models which require demand to reach a certain level before network enhancements occur.

3.6 The proactive model is also pro-competitive in that all postcodes reached in a planned roll-out become immediately available to rival retailers to provide services over the new infrastructure once it is complete. For the fixed wireless (on demand) element of our offer (which does not form part of the cost recovery mechanism) customers will still benefit from competition because these solutions can be offered by other MNOs.