Valuing Copper Access

Response on Behalf on Easynet to Ofcom's Consultation

13 May 2005

1. Introduction

Easynet welcomes Ofcom's consultation on Valuing Copper Access. This consultation comes at an important stage in the strategic review process. Its results will affect regulated input prices for all players in electronic communications markets and, in particular, on the price of unbundled local loops; the subsequent demand for broadband access; and incentives for investment. It is important, therefore, that Ofcom takes an objective and well considered view, taking account of the views of all participants in the market.

Easynet fully endorses the response submitted on behalf of UKCTA. Our comments in this document are complementary to those included in the operators' document. In this response we have chosen only to answer questions 1 – 4 and 16 - 20. Our answers to the remaining questions, including questions 21 and 22, are contained within the UKCTA response.

1. General Comments

Easynet fully supports the comments made by Ofcom in paragraph 7.17 of the Telecommunications Strategic Review (TSR) and 3.3 of the consultation document. In the light of BT's ownership of the enduring economic bottleneck of the local loop, wholesale access to this asset has taken on a renewed importance. We are perhaps less optimistic than Ofcom in our view of the potential for effective entry to occur in the long term and expect the local access economic bottleneck to endure beyond 2010. We base this view on the fact that civil engineering costs of introducing new duct capacity mean that the local access network is, to all intents an purposes, a natural monopoly in which it would be inefficient for any further entry to take place. Whilst cable operators provide competition in some geographic areas, Easynet needs to be able to offer service nationwide and for that we, and other service providers, are dependent on BT's access network.

Our answers to the consultation questions should be read in the context of Section 3 of the Communications Act:

> *It shall be the principal duty of OFCOM, in carrying out their functions (a)* to further the interests of citizens in relation to communications matters; and *(b) to further the interests of consumers in relevant markets, where appropriate by promoting competition*

Easynet believes that consumers' interests are best served through effective competition. Indeed, our competitive products are serving consumers' interests through offering innovative services at low prices. However, we also accept the reality that there is no effective competition in access nor is there likely to be so in the medium term.

In the light of the lack of effective market mechanisms to incentivise greater efficiency from BT in the design and operation of its access network, this task is left to the regulator. Price-cap regulation, through the RPI - X formula, effectively removed from BT its power to set prices and so incentivised efficiency gains. We believe this same approach should be taken to valuing the copper access network: the value should be set by reference to an efficient new entrant, rather than the existing network. Only through this mechanism will BT be incentivised to redesign its network to a more efficient topology, lowering its costs which should result in welfare gains for the citizen-consumer. We will explore this approach more fully in our answers to questions 16 – 20.

2. Questions and Answers

Question 1: *What is your opinion of Ofcom's approach to the establishment of the appropriate regulatory value?*

Paragraph 3.20 states that "Ofcom agrees that clawing back profits which are due to unanticipated efficiency gains would damage incentives to increase efficiency. However, the opportunity for over-recovery resulting from the 1997 revaluation to CCA did not result in an efficiency on the part of BT, but from a change in accounting treatment by the regulator".

In other words, BT has been able to make additional profit, not through improved efficiency on its part, but through inappropriate regulatory treatment since 1997. These profits will have occurred through above cost prices, in particular for local access, and these prices have been paid by wholesale customers. BT's additional profits have therefore been at the expense of downstream customers' own profitability which could have been used either to reduce end-consumer prices or to re-invest in innovative services.

Easynet therefore believes that the crystallised portion of over-recovery should be recovered by wholesale customers for them to use as they see appropriate.

Question 2: *What do you believe is the correct depreciation treatment for the remaining 1996/97 assets?*

For assets that were acquired after 1997, we agree that CCA should be used as this represents the replacement costs of assets used during the period that would be incurred by the efficient new entrant.

As discussed in answer to question 1, the over-recovery by BT on assets acquired before 1997 represent a loss of profit to Easynet's, and other entrants', shareholders which could have been used to reduce prices or fund new investments. We believe, therefore, that Ofcom should find a method of recovering that profit for the benefit of the industry and its customers.

Question 3: *What is your opinion of the principle of correct incentives for entry as applied within this consultation?*

The principle of correct incentives for entry is hugely important to the whole TSR process and to Ofcom's duty of advancing the interests of the citizen-consumer, which will be best served through a properly functioning, competitive market. However, we agree with Ofcom that entry in local access is unlikely in the medium term, or even the long term, and that therefore BT's behaviour can only be constrained by regulation.

Entry into local access represents a sunk cost as it is unlikely that the passive parts of the infrastructure could be re-used for other purposes. This causes a problem with regard to market entry for in a market characterised by sunk costs a less efficient operator will not necessarily be replaced by a more efficient one[1]. Therefore, as we discuss in our answer to question 16 – 20, the regulator needs to play the part of the hypothetical efficient new entrant to constrain the incumbent's costs and stimulate efficiency gains.

[1] See de Bijl, P. and Peitz, M. (2002) *Regulation and Entry into Telecommunications Markets* Cambridge University Press, p242.

As we will discuss later, though, we do not agree with the concluding sentence of para 3.34 which states that Ofcom is not planning to revalue BT's copper on a Modern Equivalent Asset (MEA) basis.

Question 4: *Do you believe that these criteria are appropriate? What other criteria, if any, would you apply?*

We discuss each of the criteria below.

- *the method should be as simple as possible and consistent with the regulatory accounting principles of objectivity and transparency;*

We propose that the phrase should be slightly altered to read "the method should be as simple as is appropriate in the circumstances and consistent…" Whilst we appreciate simplicity, this should not be a goal in itself. Some of the issues are complex and require detailed analysis. Ofcom should ensure that issues are fully and appropriately analysed, accepting that this may require complexity, though not at the expense of clarity.

- *the costs of implementation, and the burden on both industry and regulator, should not be disproportionate to the benefits to be gained by citizen-consumers from a more appropriate valuation and so the valuation should be practical;*

Agreed.

- *there should be minimum regulatory uncertainty moving forward so the chosen method should be robust and able to cope with anticipated future changes to the competitive market for local access;*

Regulatory certainty is critical for investors, so in principle we agree. However, we are confused by the phrase "…anticipated future changes…" and would welcome clarification from Ofcom on what future changes it anticipates will take place in the local access market.

- *it should be based on objective data sourced from within industry, primarily from within BT's regulatory accounting system, such that industry and citizen-consumers can be confident that charges reflect costs as accurately as possible;*

Again we agree in principle. However, we are concerned by the reliance on BT's regulatory accounting system. This will necessarily be an important source of information but for the industry and the citizen-consumer to be confident of its veracity, information from within BT will need to be verified against objective, external data sources.

- *the chosen method must be underpinned wherever possible by a sound economic rationale*.

This criterion does not add value and should be removed. Ofcom will be aware that "sound economic rationales" can be applied to both sides of a dispute and different theories can be applied dependent on the desired objective. The phrase "wherever possible" further weakens the criterion.

Question 16: *What is your view of adopting a proposal which leaves the existing approach unchanged?*
Question 17: *What is your view of adopting a proposal which applies the adjustments described to the existing approach?*
Question 18: *What is your view of adopting a proposal which applies the adjustments described in proposal 1, plus an efficiency adjustment derived from the WIK Consult work, to the existing approach?*
Question 19: *What is your view of adopting a proposal which bases the valuation on that of a hypothetical modern equivalent network using an optimised deployment of duct and copper cables?*
Question 20: *What is your view of Ofcom's proposal to use Proposal 1 as described above?*

Rather than answer these five questions separately, we have chosen to provide a single answer to all five. We first discuss BT's enduring market power before explaining why we believe that Proposal 3 is a more powerful incentive for efficiency gains by BT. Next we discuss the data requirements for Option 3. Finally we give our reasons for rejecting Proposals 0 to 2, except that Proposal 1 may be used as an interim measure whilst further data are gathered for Proposal 3.

BT's Market Power

The market for local access remains an enduring economic bottleneck and non-contestable. We take a more pessimistic view than Ofcom and suggest that even in the medium to long term, there is unlikely to be sufficient competitive entry into the access market for BT to be constrained by competition. Likewise the lack of a threat of entry does not provide a similar constraint. This is because BT has a ubiquitous access network and the sunk costs for any company to duplicate that network would be prohibitive. In economic terms, competitive investment would be inefficient.

This does not preclude competitive entry in some geographic areas, as is the case in the former cable franchise areas. However, such access level competition as does exist is imperfect in that it is only in about half of the country whilst the rest remains non-contestable. Any service provider which wishes to provide a nationwide service is still dependent on BT for access and does not possess sufficient buyer power to constrain BT, not least because such a service provider is subject to major significant switching costs if/when they switch customers to cable, but also cable access networks cannot be used to replicate all of the products that are available using BT's network.

In these circumstances of high sunk costs and imperfect competition market entry cannot always be expected even if the incumbent is inefficient[2].

From the perspective of the citizen-consumer, the effect of this "natural monopoly" is that BT is not - and will not be in the future - subject to external incentives to improve efficiency and to pass those improvements onto consumers. It will therefore always be necessary for Ofcom to regulate the access network. To ensure consumers gain from such regulation, Ofcom must regulate in a manner which incentivises both dynamic and static efficiency gains. This means that Ofcom needs to use high-powered, incentive regulation.

[2] De Bijl and Peitz *op cit*

Incentive Regulation

In a competitive or contestable market, no firm is able to act in a manner independent of its competitors and customers. It must respond to external pressures to drive down its own costs and to innovate new products and services, or it will suffer lost revenue and profits. Price cap regulation has the effect of mimicking competitive forces by removing control of prices from the regulated operator, forcing it to gain efficiencies to retain profitability. Whilst it may not have an unblemished record, the RPI – X formula has been effective at driving down consumer prices since it was first imposed in 1984 and consequently has incentivised BT to become more efficient.

To take these efficiency gains further, we believe that Ofcom should remove any control of the value of BT's copper from BT itself and use the benchmark of a hypothetical entrant using Modern Equivalent Assets (MEA) to arrive at a value for BT's copper. Therefore, Easynet supports Ofcom's Proposal 3 as the best way to arrive at market-based value of BT's copper access network.

Under CCA principles, the Value to the Business (VTB) of an asset is the lower of the replacement cost (calculated on a MEA) and Recoverable Amount (RA), where RA is the greater of net realisable value and value in use. In a competitive market, the value in use (i.e. the discounted present value of the future cash flows expected from keeping the asset in its current use) will be affected by the efficiency of the nearest rival's equivalent asset.

Assume there are two rival firms (A and B) each operating assets to provide perfectly substitutable services, which consumers purchase only on price. Let the asset of firm A = α and the asset of firm B = β, the operating cost of each asset = Cα and Cβ respectively and the price that each firm can charge = P_A and P_B. Each firm's costs, other than the asset are the same, thus the only influence on price is the cost of the asset.

If Cα > Cβ it follows that $P_A > P_B$ (assuming marginal cost based pricing) and that firm B will sell more units than firm A. To sell the same amount as B, P_A must = P_B.

As the value in use of an asset equals the cashflow the firm receives from the asset (assuming no discounting for the time value of money), and cashflow equals price times volume, then the value in use equals price times volume. If B is the price setter i.e. the more efficient of the two firms, then the value to the business of α to A is set by Cβ, and not by any internal measure. The opposite applies if A is more efficient.

If the hypothetical new entrant has built its network using a MEA, and its costs are lower than the incumbent's, it follows that the VTB of the incumbent's network would be set by the costs of the MEA. Therefore the use of the hypothetical MEA is the best way to regulate a monopoly asset to provide incentives for efficiency gains. In our example, there is a strong incentive for firm A to lower Cα to no more than Cβ to allow it to remain consistently profitable.

Regulatory certainty is essential to encouraging efficient investment into the telecommunications market. Any uncertainty will tend to make investors more cautious, discouraging entry as deep in the network as possible. For this reason, we propose that, upon adoption of Proposal 3 it should be left in place for a period of five to seven years.

Data Requirements for Option 3

Easynet recognises that the data requirements for Proposal 3 are significant and so proposes that Ofcom should embark on a data collection and analysis exercise to gather sufficient quality data to implement Proposal 3.

There are two areas of data gathering and analysis where more information is required. First, the WIK Consult model is based on just five of BT's exchanges (compared with 10% of Deutsche Telekom's exchange for the equivalent German model). Ofcom place a margin of error on the subsequent results of ±20% which is unacceptably large for such an important exercise. It would therefore be necessary for Ofcom to expand this sample substantially to obtain more accurate results.

Secondly, the Analysys model of the MEA was based on a sample of just eight, out of a total population of 5,500 exchanges. Ofcom believes that this sample is large enough on the basis that it covers each of BT's six geotypes.

We find it surprising that Ofcom can make a statement as conclusive as it makes in para 4.90 where it rejects this option on such a limited dataset. Taking the results of one exchange from each geotype and regarding that as conclusive evidence that a switch to an MEA would make marginal savings is wholly inadequate given the importance of this exercise in the TSR process and in driving down the cost of copper access and stimulating efficiency gains by BT.

Again, therefore it is essential that Ofcom undertakes the same analysis using a representative sample of exchanges.

Comments on Proposal 0, 1 and 2

In the event that Ofcom considers that it has insufficient data to implement Proposal 3 immediately, Easynet would support the short term introduction of Proposal 1, for no more than one year, whilst the data is collected and analysed to implement Proposal 3.

In common with Ofcom, and UKCTA, we reject Proposal 0. The consultation document demonstrates that there are too many weaknesses in both principle and practice with this approach to make it tenable in the future. In particular, as we discussed in our answer to question 1, the current system allows profits to be diverted from new entrants to BT, preventing firms from investing in new services and/or offering lower prices to our customers.

We also reject Proposal 2 which we regard as a half way house between the present system and a true market-based valuation.

Proposal 1 only has merit as an interim solution if more data is needed to implement Proposal 3. It removes one of the major anomalies – the over-recovery of 1997 assets – but is not market based. It therefore would not provide the external incentives to BT to introduce a more efficient network with all the commensurate gains for the citizen consumer.