Valuing copper access

Part 2

ntl Consultation Response

Introduction

This document sets out ntl's response to Ofcom's second consultation on valuing the BT copper access network. As an owner and operator of a significant access network, we are more concerned with the consequences of this valuation exercise and less with the detail of the methodology which produces the result, and the comments made herein reflect these concerns.

In particular, we draw attention to the fact that our access network was built to enable the delivery of multi-channel TV services. As such, we have optical fibre running very close to customer premises. In essence, we own a 'next generation' access network. Ofcom should be aware that the valuation of BT's current generation network indirectly affects the value of competing access infrastructure. We believe Ofcom should explicitly acknowledge that the consequence of this exercise may be to devalue the UK's only next generation access infrastructure.

This introductory section highlights two fundamental issues for ntl. The remainder of the document addresses the questions posed by Ofcom in the consultation.

Pricing and signals for efficient investment

Our greatest concern is the apparent lack of consideration of the effect that regulatory pricing decisions will have on *investment in existing networks*. This is an issue ntl has raised in many of our recent submissions to Ofcom. The consultation document only discusses investment incentives in the context of entry and exit. The sentiment is expressed clearly in paragraph 3.51, which notes that since existing levels of access competition are low and new build of additional access infrastructure is unlikely, then "the relative importance of investment incentives is low in the short to medium term although the development of competing networks in the longer term is possible".

The focus on entry and exit is common in the economics literature, especially when discussing the signalling effects of prices. However, this results from a very narrow view of investment, and a highly stylised and simple model of competition in which firms produce a single homogeneous product. In applying the theoretical economic models, Ofcom must take account of investment to maintain and upgrade the existing infrastructure. In more mature markets such investment is likely to have a more beneficial impact than new entry.

It is likely that price levels which encourage efficient entry and exit decisions will also send the appropriate signals to encourage efficient investment in existing infrastructure. Furthermore, given the fact that the demand and supply for access network capability is currently undergoing rapid change, we believe it is hard to sustain the argument that the importance of investment incentives is now relatively low.

Impact Assessments

The second and closely related issue is that the impact assessment contained in the consultation document is inadequate. Although the consultation does analyse the impact of changing various accounting assumptions on the valuation of the cost of copper, less consideration is given to the effect that changing the cost of copper will have on relevant stakeholders. It is in this context that we believe the effect on investment in existing infrastructure should be considered.

It is possible that this type of impact assessment will be conducted further into the implementation phase, i.e. whilst setting regulated wholesale prices. However, we believe there is a tendency to assume that the impact assessment has been conducted as part of the Strategic Review. In this scenario, impacts are assessed relative to the preliminary conclusions of the Strategic Review. The risk is that many of these preliminary conclusions have yet to be rigorously tested.

For example, the statements made in paragraph 3.55 relate to the Strategic Review conclusions, and are all reasonable. However, none of them are substantiated through a rigorous argument. Since they form the principles on which the rest of the analysis is based, this appears to be quite a large omission from the impact assessment.

Response to Consultation Questions

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

In general, we support the position put forward by Ofcom that a new approach should not be adopted "without clear evidence that it would be superior to the current approach and is proportionate to the problems identified" (paragraph 3.27). In this sense, defining a "regulatory value" that differs from standard accounting measures of value can only be appropriate if it contributes to the achievement of regulatory objectives.

Without commenting specifically on the chosen objectives, ntl believes that a regulatory value will be appropriate if it results in prices that encourage efficient levels of investment by both new entrants *and* existing firms. This implies that the regulatory value will measure the cost (or market value) of a new entrant building a new network today.

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

The correct depreciation will be one that encourages efficient levels of investment. In this sense, we believe costs should be set on a forward-looking basis. In which case, the depreciation treatment for assets that are partly written down is not a relevant consideration.

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

As discussed in the introduction, we are extremely concerned that Ofcom should ensure incentives are correct both for entry *and for ongoing investment*. In theory, there is one price which will provide the correct incentives for both.

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

The current criteria are appropriate, and we don't believe any more are required. However, we would encourage emphasis on the need to minimize uncertainty. Similarly, in keeping uncertainty to a minimum we strongly support the idea of keeping the analysis as simple as possible.

Question 5: Do you agree that Ofcom should adopt 20 years as the appropriate book life for copper cable?

Yes.

Question 6: Do you agree that Ofcom should adopt a straight line depreciation of 40 years as the appropriate book life for duct?

Yes.

Question 7: Do you agree with Ofcom's approach to spare capacity?

The approach to spare capacity seems to be reasonable. However, the approach to copper lines lost to competition does not seem to make sense. In order to be able to serve a particular geographic area a network operator will need to build the access network at least as far as the drop wire for every premise passed. The alternative would be civil engineering work every time a new customer requested service. Therefore, even an efficient new entrant rebuilding the capability of BT's current infrastructure would not reduce costs by any meaningful amount. In fact, there is a very strong argument to suggest that the cost per line actually increases.

If Ofcom is to implement reductions in the cost of copper due to lines lost to competition we believe further explanation is required.

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Question 8: Do you agree that Ofcom should continue to use the labour rates as used by BT in LLCS and that the existing method of indexing these each year should be retained?

If the methodology is based on a valuation of a rebuild, then the relatively low labour rates seem appropriate. However, if the aim is to calculate BT's current costs for maintaining the network, then more recent labour rates should be used.

[Is there a reason why the cost for 10 bores is disproportionately high?]

Question 9: Do you agree that Ofcom should not apply an abatement for cable modularity given the analysis results?

Yes.

Question 10: Do you agree that Ofcom should not change the existing method by which the costs of shared duct are allocated between access and core?

Yes.

Question 11: What is your view of applying an efficiency adjustment to the access network operational costs?

A reasonable approach would be to establish the current costs of building and operating BT's network, and then to establish a separate cost associated with a hypothetical efficient new entrant. There should then be a separate regulatory pricing decision. This latter decision should consider which of the two costs to use, taking into account the incentive effects of the prices. It may be the case that one adopts a weighted average of the two values to reflect competing regulatory objectives.

Question 12: What is your view of Ofcom's analysis of this approach? Do you believe that it is valid to use an optimised copper network, although hypothetical, to inform the valuation process?

Clearly a hypothetical model is only useful if it bears close relation to the costs that would be incurred by a new entrant. There is very little point in knowing what cannot be achieved in real life. Ofcom should only be interested in the cheapest possible realistic network cost.

Question 13: What is your view of Ofcom's analysis of this approach? Do you believe that an optimised network using modern technology is an appropriate basis for informing the valuation of BT's copper access network?

This analysis should reflect the commercial reality faced by firms operating today. In this sense, the constraint that the MEA based network should have the same capability as the existing BT network is unrealistic. A firm considering building a new network or considering upgrading their existing network would not almost certainly do so with the aim of improving the network's capability. For this reason, we are unsure that the MEA approach is useful.

Question 14: What is your opinion of Ofcom's approach to calculating the over-recovery (or under-recovery)?

We have two comments in relation to this issue:

1. The existence of an over or under recovery depends on whether or not BT's historic prices were strictly cost based and reflecting asset depreciation profiles. If this is not the case, there need not have been an over-recovery in real life. In general, the theoretical argument for an over-recovery relies on several assumptions, and the consultation document does not investigate whether these assumptions hold.

2. Over or under-recovery **must** relate to something that happened in the past, i.e. historic depreciation profiles. This is true even for the un-crystallised portion of the over-recovery. This implies a shift away from an entirely forward looking cost methodology. One can make adjustments going forward as Ofcom suggest, but this remains an inherently backward looking approach.

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Question 15: What is your opinion of Ofcom's proposals to disallow the over-recovery between 2004/05 and 2009/10?

Please see response to previous question.

Question 16: What is your view of adopting a proposal which leaves the existing approach unchanged?

Assuming the accuracy of the current method is poor, then it appears that there is a need to change the approach. However, if Ofcom's ultimate conclusion is that a new approach would only result in a very small change in the cost of copper (leaving aside the effects of a possible change in cost of capital), then some form of cost benefit analysis should be undertaken with respect to the adoption of the new approach.

Question 17: What is your view of adopting a proposal which applies the adjustments described to the existing approach?

See responses to earlier questions.

Question 18: What is your view of adopting a proposal which applies the adjustment described in proposal 1, plus an efficiency adjustment derived from the WIK Consult Work, to the existing approach?

It is difficult to understand what the final cost, or value, figure would represent. Fort this reason alone, there seems to be little point in pursuing this option. Also, see response to question 11.

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?

A hypothetical new entrant cost model must measure the costs that can be realistically achieved by a real firm in the current market environment. However, it must be accepted that this is likely to cost a great deal more than the current network. This raises a fundamental issue with the analysis. A real new entrant would build a network with greater capability than the existing infrastructure.

Therefore, these costs of this network are perhaps the most relevant in terms of investment incentives.

Question 20: What is your view of Ofcom's proposal to use Proposal 1 as described above?

Subject to a thorough Impact Assessment, this seems like a reasonable approach.

Question 21: Do you agree that the RAV should be based on the closing net book value in the 2003/4 financial year of assets in situ as of 1 August 1997 and that the approach should be implemented in the 2005/6 financial year? If not, on what do you believe Ofcom should base the RAV, when should this be implemented and why?

This should be assessed with respect to the impact that it will have rather than trying to conjure up an objective justification for the approach.

Question 22: Do you agree that the appropriate index for the RAV in the 2004/5 financial year is an RPI of 3.2% and do you agree that RPI should continue to be used for the future indexation of the RAV? If not, what index should be adopted and why?

RPI seems like the least controversial measure.