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Dear Steve,

Ofcom's approach to risk in the assessment of the cost of capital

Estimation of the cost of capital will never be an exact science. Given this inherent uncertainty, we believe Ofcom should be more concerned with the impact of adopting a particular cost of capital, rather than the methodology used to produce the figure. It is, of course, important that Ofcom adopt a consistent methodology in order to promote transparency and thereby minimise regulatory uncertainty. Ultimately, however, Ofcom must judge the appropriateness of its interventions based on the effect that they are expected to have.

ntl believes that a figure of just over 10% represents a reasonable estimate for the cost of capital for the parts of BT relating to the access network. Similarly, we feel that a figure of just over 11.5% is reasonable for the remainder of BT's operations. However, we do not feel that Ofcom has yet given sufficient justification for the disaggregation of BT's beta, both in terms of the theoretical case for disaggregation, and in terms of the benefits it is expected to bring relative to a single beta estimate.

The remainder of this letter discusses the following two issues¹:

1. The rationale for distinguishing between BT's copper access network and the rest of BT; and,
2. The impact the proposed change in regulation will have on incentives to invest in next generation access networks.

Disaggregating the beta

It is clear that different parts of any business may face different systematic risks and therefore ought to earn different rates of return. However, it is not

¹ These are discussed further in the ntl response to the first consultation on cost of capital.

always obvious which activities or business divisions ought to be treated differently. It is therefore important to establish a robust theoretical model to explain the variation in systematic risk across BT Group operations *before* embarking on empirical estimation of the beta(s). Without this theoretical justification, one runs the risk of collecting spurious statistics.

Even without sector specific expertise, intuition would suggest that a network access business under little threat from competition will have a relatively low risk profile. Equally, the returns of businesses operating in more competitive markets where barriers to entry are much lower are likely to display much greater variation. However, this intuitive understanding is not sufficient to delineate between the high and low risk functions of BT's business with a degree of accuracy sufficient to inform empirical analysis.

In our previous response we suggested that systematic risk may be causally related to competitive conditions.² The example was given simply to draw attention to the need for a robust theoretical model of systematic risk. If there is a link between competitive conditions and systematic risk, which does not seem unreasonable, then it may not be appropriate to use beta estimates of utility companies as a proxy for BT's copper access network beta.³ That is, without a strong theoretical foundation, empirical analysis may be misleading.

A robust theoretical argument would also clarify the set of assets and operations that are thought to be lower risk. Clearly, it is not necessary at this stage to provide a precise list of assets and operations, but an understanding of the principles would greatly enhance transparency over the justification for disaggregating the beta. The level of detail provided by Ofcom so far is insufficient to understand this justification. For example, does BT's 'copper access network' include just copper assets; the metallic path facilities (MPF) used in local loop unbundling; MPF and the remaining supporting physical infrastructure (e.g. duct, poles, street cabinets, etc); or perhaps, all PSTN related assets from the local exchange to the customer premises?

For the avoidance of doubt, we believe Ofcom should offer a more robust theoretical justification for the disaggregation of the beta. Justification based on intuition and empirical analysis alone is inadequate. One final test that Ofcom must apply before adopting the new proposals is to assess whether or not the net benefit of disaggregating the beta is positive *relative to a single group beta*.

² Incidentally, this is the reason for suggesting that disaggregating BT's beta along geographic lines might be justified – in cable areas BT faces competition at every stage of the value chain, whereas outside these areas BT is often a monopoly supplier.

³ However BT's copper access network is defined, it definitely faces competition from the cable industry across approximately 50% of the population. Increasingly, it also faces competition from mobile networks. In contrast, the *network* operations of other utility companies face no direct competition.

Investment incentives and next generation access

The most recent consultation document states that, “Ofcom’s aim is not to encourage investment in next generation access *per se*, but, rather, to obtain the benefits that next generation access networks will bring relative to current generation access priced at a fair level.”⁴

Unfortunately, it does not make sense to upgrade individual customers to next generation status. The investment decision faced by network operators is to upgrade all customers in a relatively large area, or do nothing. Therefore, to some degree, next generation network investment will have to be made in anticipation of demand: some of the customers will have wanted, and be willing to pay for, the upgrade, whilst others will not.

If there were only one access network operator, then prices could be raised following the upgrade to help recover the investment cost. Therefore, even consumers who were unwilling to pay for the new services and functionality would be forced to contribute. Where there is more than one network operator, the first to make the upgrade investment is only likely to capture customers who are willing to pay for the enhanced services. This is a reasonable description of the situation for roughly half the population served by both BT and cable networks.

The result is that in such areas next generation access investment will only become viable when a sufficient amount of unfulfilled demand has built up for the enhanced services. Assuming a chain of substitution (asymmetric or otherwise) between current and next generation services, and assuming demand is price elastic, then a reduction in the relative price of current generation network services will tend to reduce the amount of unfulfilled demand for next generation services at any point in time.

Our conclusion is twofold. First, Ofcom should acknowledge that reductions in price for current generation services will affect incentives to invest in next generation networks. The lower the price for current generation services, the longer the delay before next generation access investment becomes viable. Secondly, as the unfulfilled demand for next generation network services increases, Ofcom’s aim is likely to shift much closer to the encouragement of investment in next generation access networks *per se*.

Yours sincerely,

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⁴ Paragraph 4.29