

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title: Approach to risk in the assessment of the cost of capital

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Representing (self or organisation/s): Intellect

Address (if not received by email):

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What do you want Ofcom to keep confidential?

Nothing

Name/address/contact
details/job title

Whole response

Organisation

Part of the response

If there is no separate annex, which parts?

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Name **S R Hearnden**

Signed (if hard copy)

INTELLECT'S RESPONSE TO OFCOM'S CONSULTATION IN ITS APPROACH TO RISK IN THE ASSESSMENT OF THE COST OF CAPITAL

Intellect is the trade association for the information technology, telecommunications and electronics industries in the UK representing 1000 organisations spanning blue-chip multinationals to early stage technology companies. Intellect members contribute around 10% of UK GDP. Further information about Intellect can be found at www.intellectuk.org

Intellect welcomes the opportunity to comment on this consultation. The main themes of Intellect's response are as follows:

General principles

Intellect is of the view that a sustainable competitive telecoms market is a prerequisite for a successful knowledge driven economy, the growth of the UK and is good for the citizen consumer.

Innovation and investment will be encouraged through the development of competitive markets with minimal regulation. Where regulation is required, ensuring that it forms part of a stable framework and that those making investments are allowed to be appropriately rewarded for the risks they incur.

Intellect's Vision

Voice telephony and narrowband internet access have established a near universal trend as more and more commercial and social activities come to be dependent on such services.

There is every reason to believe that broadband will accelerate the trend because of the increasingly rich variety of activities that can be supported. In the light of this, an essential enabler of a successful knowledge based economy will be the development of the necessary infrastructure to support freely available, affordable access to broadband services for all.

The desire is for open and freely available access to fixed and mobile broadband infrastructure, for both users and service providers. The underpinning broadband infrastructure must be capable of delivering adequate levels of availability, resilience and dependable quality of service.

Next Generation Networks

We are on the cusp on the potential rollout of Next Generation Networks (NGNs). Such networks can enable the delivery of many new services (e.g. broadband, mobility, ICT, etc) to the benefit of the citizen consumer, as well as all the services previously provided over existing separate disparate networks.

The intelligence associated with services is unbundled and now resides in servers that can be accessed by the services. NGNs can deliver significant capital and operational expense savings in comparison with the parallel deployment of separate, disparate networks.

Next Generation Networks enable services to be offered with a wide range of quality and service attributes. They remove many of the restrictions on 'who does what' and 'where'. They connect an end user to any server enabling services such as voice, multimedia, and authentication to be provided from anywhere in the network.

Next Generation Networks are poised to revolutionize the way we live. They have the potential to create huge opportunities in terms of economic development, environmental efficiencies and social gains. They can enable teleworking, underpin economic growth and

transform learning and leisure.

Significant investments are required to ensure that readily available 'access for all' in new services and the underpinning NGN infrastructure. If the UK is to gain these benefits and maintain economic competitiveness to the full, it is imperative that a stable regulatory framework is established, where investors can be appropriately rewarded for the risks that they incur.

In this context, Intellect applaud in general terms the approach that is proposed by Ofcom in ensuring better assessment of risk in its assessment of the costs of capital. Our response to more specific points raised by the questions is detailed below:-

Answers to questions

Question 1: *Do you agree that 2% to 5% represents a reasonable range of values for the ERP? Within this range, do you agree that Ofcom should revise its central estimate downwards from 5% to 4.0% or 4.5%? Which of these is the most appropriate?*

The approach taken by Ofcom, in considering evidence and benchmarking for an appropriate rate of ERP from a wide range of sources, including those used by other UK economic regulator and the Competition Commission, is to be welcomed.

However capital markets as are telecom networks are global, to set a level of new level of ERP without also benchmarking against European and other key regulators could result in a level of ERP that is detrimental to UK investment in NGNs.

As outlined in the introduction, a sustainable competitive telecoms market is a prerequisite for a successful knowledge driven economy and the growth of the UK. When making a final decision on an efficient level of ERP, Ofcom should pay due regard to how this will be viewed by investors in relation to the UK main trading partners and competitor economies.

Questions 2 and 3:

Do respondents think that if projects with different risk profiles are to be rewarded differently, this should be through the cost of capital or the cash flows or should it depend on the types of risks involved? How would such extra (or reduced) rewards be treated in future financial analysis (e.g. at future charge control reviews)?

Do respondents think that projects or business units with different systematic risks should be rewarded differently? If so, is it possible to establish a robust methodology by means of which the systematic risk of these projects could be assessed and the adjustment to the reward determined?

NGNs can enable the delivery of many new services (e.g. broadband, mobility, ICT, etc) to the benefit of the citizen consumer, as well as all the services previously provided over existing separate disparate networks. They will enable services to be offered with a wide range of quality and service attributes removing many of the restrictions on 'who does what' and 'where'. They are poised to revolutionize the way we live creating many opportunities for market players.

However, NGN's will require huge investments and unlike the traditional voice networks, there will be new and significant increased risks associated with technological uncertainty as well as market demand risks associated with new product introduction. If investments are to

happen, then the regulatory framework will need to ensure investors are appropriate rewarded for the risks incurred.

The level of risk will vary relating to the scale and scope of NGN investment. Figure 1a highlights the breakdown of the various elements that can make up an NGN infrastructure, whereas figure 1b relates this to the level of risk and investment horizon. It should be noted that the lower level passive infrastructure exhibits a lower level of financial risk (and lower returns), however this often accounts for the most significant part overall investment e.g. for a fixed network this is often estimated at 75% - 85% of total investment costs.

Figure 1a NGN infrastructure

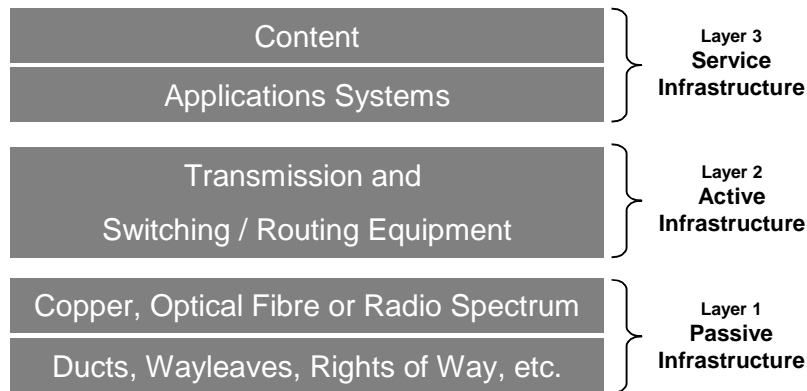
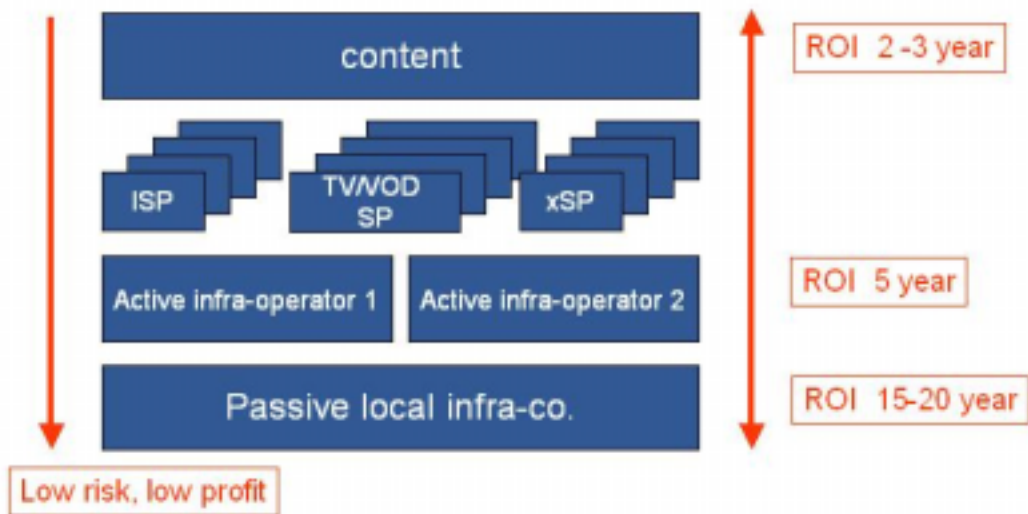


Figure 1b Differences in investment horizons



In the consultation document, benchmarking has been undertaken against other UK utilities, from which the conclusion is also drawn that the risk (beta) associated with an access infrastructure business would be below the average. However, it should also be considered that there are much greater risks associated with a telecoms copper access infrastructure than say a typical utility access infrastructure, given the additional demand risks associated with telecom products as well as the multiple technology substitution threats from cable, fibre, wireless (incl mobile) and satellite.

For Ofcom to make judgement on all risk profiles may be too complex and lead to excessive regulatory intrusion. However given these very different risk profiles, to reward projects based on an average is likely to lead to inefficient investment. Given Ofcom's recommendations in the Phase 2 STR, if accepted, then it does become possible to focus the assessment of risk by Ofcom solely on the economic bottleneck of the passive access infrastructure, negating the need for Ofcom to regulate higher level networks and applications.

Questions 4 & 5:

Do respondents agree that it is appropriate for Ofcom to disaggregate its estimate of BT's equity beta, and in particular to estimate a distinct equity beta for BT's copper access network?

Do respondents agree with Ofcom's approach to assessing possible values for the equity beta of BT's copper access network, and its suggested range of values?

Intellect does not comment on specific questions about one of its members

Question 6:

Do respondents agree that initial appraisals of projects with high specific risk tend to underestimate the true expected costs of the project? If so, how should the true expected cost of the project be assessed and any adjustment to the required reward determined.

No specific comments provided on the adjustments required to offset optimism bias. However, as outlined in the response to questions 2 and 3, the scale of investment in access infrastructures needs to be emphasised, making it important that Ofcom make allowances for the true expected costs of projects.

Question 7:

Do respondents agree with Ofcom's suggested assessment of the likely circumstances under which real option theory will be applicable in the context of regulation?

The telecommunications market, and particularly the potential deployment of NGN's, is exhibiting increasing risks for investors, as they are exposed to greater uncertainties relating to increased competition, uncertain market demand for new services and risks from the deployment new and untested technologies.

Regulation is in effect the removal and / or award of 'real options' between different market players. In a stable market environment 'options' have minimal value, and their complexity probably outweighs any benefits of the use. However, with the telecoms market becoming increasingly uncertain, with greater risk associated with investments, then the use of 'real options' becomes far more applicable.

In the context of NGN deployments, real option values may be extremely high (several £Bn's), consequently Ofcom may be maybe making decisions that involve the transfer of all or part of this value between market players. It is important, in contrast to Ofcom's proposals in the consultation that in ensuring transparency Ofcom should consider both the value of options that are given up as well as the options acquired by other parties. Otherwise decisions may be taken that lead to inefficient long term investment priorities, at the expense of short term competitive gains.

Question 8:

Do respondents have any views on how the value of real options might be taken into account in practice in a regulatory context?

The initial analysis undertaken by Ofcom (figure 12) seems an appropriate initial assessment of where real options may be suitably applied in practice. Although there are difficulties in accessing the value of real options due to their complexity and modelling in real-life situations. However, with increasing uncertainty associated with the telecoms sector and investment in NGNs, their value may be so significant, that even using approximations, will be preferable to not considering them at all.

Conclusions

Intellect applauded the general approach adopted by Ofcom in establishing an improved framework for the assessment of risk. Investment in NGNs is essential for UK competitiveness, growth of the economy and ultimately for the benefit of the UK citizen-consumer. Investors must be allowed to earn the appropriate return for the risk that they incur. In this context, we would request that Ofcom considers the points raised in this response, particularly the benchmarking of ERP against European and other key telecom regulators, as well as the full consideration of both the value of real options given up as well as added, to ensure efficient sustainable investment in NGNs.