Broadband intervention: Just putting money into holes in the ground?

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New pipes?

Broadband access is seemingly coming of age. Proper broadband access for both homes and businesses (i.e. at DSL speeds and greater) is increasingly seen as basic a requirement as the more traditional utilities.

A new set of pipes, but who will finance them? Now that customers have become accustomed to DSL access speeds, talk has turned to Next Generation Access (NGA). Some incumbents are considering rolling out NGA, to deliver the next generation of bandwidth- hungry applications, whilst the talk amongst National Governments and Regional Authorities, focuses upon encouraging the information economy and pushing e-Government.

Essentially, NGA is likely to require the rollout of fibre, lots of fibre, to the kerb or the home. Capex costs will be high and the "Killer applications" that will encourage consumers to pay are still in the development stage.

On-demand television seems like a viable proposition, but even this is as yet unproven, and the relationship between providers of such services and national broadcasters yet to be tested or forged.

Everybody wants broadband

Despite the uncertainty about what this new infrastructure will transport, at the macroeconomic level there seems to be a great deal of consensus that access to broadband is a "good thing".

Certainly the story of South Korea seems to be a difficult one to ignore. Given that it was among the nations hardest hit by the Asian financial crisis of the late 1980s, rather than retrench, the country turned a disaster into an opportunity.

Spending on broadband and other high-technology gear helped lead a transformation of the economy, pushing the overall information technology sector to about 13 percent of economic activity and making South Korea much less dependent on heavy industry.

Surely it is examples like these that encourage the ITU to argue that: *"Broadband has been referred to as the infrastructure of the knowledge economy. Countries around the world have nominated broadband networks as crucial infrastructure for achieving their social, economic and scientific goals".*[1]

The European Commission agrees and says: *"Access to adequate broadband services [is of] crucial importance to our economic and social development".*

Given these well-acknowledged benefits Governments and Authorities will surely consider following the South Korean example by intervening in the market, which in Europe may be fraught with difficulty and will likely require, depending upon the extent and nature of the intervention, a State Aid notification and a decision from the regulators in Brussels.

DG Competition will look, amongst other things, at the proportionality of the intervention and the levels of support as a percentage of the total project cost, or State Aid Intensity (SAI).

In our experience, the demands of the Commission will require a well developed and accurately costed Business Plan that includes detailed mapping and coverage analysis.

This latter element of the plan should be compiled in consultation with existing operators; such consultation helps to target underserved areas and avoids a damaging fight with the incumbents. In addition, the Commission guidelines state that the network should have been procured on the most "economically advantageous" and technology-neutral basis.

What this means in practice is that the procuring Government/Authority will require a fully transparent procurement process for both equipment and operator (assuming that the Authority cannot/does not want become the operator itself).

This process should culminate in the establishment of an open-access, wholesale operation, steering well clear of intervention at the retail layer.

However, such a structure lands the interventionist Authority on the horns of a dilemma.

The open-access wholesaler will be required to cover areas where "market failure" is deemed to exist (i.e. all those places where the incumbents have deemed it to be unprofitable to invest), and to provide backhaul services to retailers and ISPs at a price comparable to or lower than the best in the region. This inevitably makes the business a Capex-hungry and revenue-light model that will take considerable support from the Authority to attract operators seeking to make adequate returns. Indeed, it will be extremely difficult to structure injections of public money in a way that avoids breaching the Commission's SAI guidelines

1. ITU, quoted in Broadband in Europe: how Brussels can wire the information society

Structure is key

The intervening Authority will be well advised to develop or commission a finely honed financial modeling with dynamic SAI calculations, such a tool will be crucial to discussions with the Commission. The project will also require a commercial structure that responds to the market with additional cash-calls and /or claw back mechanisms that will allow for additional Capex or a limitation on "excess" profits.

The problem with such measures is that they are likely to further discourage potential operators – adding complexity whilst limiting upside.

There are other non-financial moves for the Authority, but these are unlikely to make the project "bankable" in themselves. Administrative assistance through network rollout is on option. The Authority can help, through the granting of wayleaves and/or assisting with access to existing infrastructure such as ducts or sewers.

The Authority's investment may be topped up with EU grant funding, which would not count towards the SAI calculation. But whilst these measures will limit Capex somewhat, they are unlikely to add substantially to the project's revenue generating capability.

Consequently, it may be tempting for the Authority to consider intervening on the demand side, as priming the market will doubtless increase project revenue as well as helping to achieve its development objectives.

Whilst it is be perfectly legitimate for an Authority to build a network for its own use. Should the Authority choose contract the bulk or all of its business to an operator it has subsidized enabling that entity to expand its commercial operations, such a cozy commercial relationship may well attract the attention of the incumbent operator and result in a State Aid challenge.

If public money is to be invested, the Commission will deem such aid to be allowable if it is assessed as being on "market terms".

This, at first glance, seems to be a restriction too far since any intervention designed to combat "market failure" cannot, by definition, be structured on "market terms".

However, bank financing would be proof-positive that the Project is in the market, and a long–dated facility from an EIB or similar is the most likely way to finance a utility with relatively thin cash flows. A Guarantee Facility covered for the first x years by a syndicate of eligible banks would maximize liquidity in that market and leave only the re-financing risk in place which may be acceptable if the project IRUs are sufficiently long dated and the off takers sufficiently bankable.

In summary, any European Authority wishing to intervene in rolling out broadband – as they may now be tempted to do, should prepare carefully; they will surely need a well-crafted business plan that is acceptable to the Commission from the point of view of limiting market distortion; but also acceptable to the bankers who will want to see credible cash flow projections generating adequate debt service coverage.

Not many Authorities have yet attempted this tricky balancing act of public and private financing together; the Fibrespeed project in Wales and the Irish MANs were funded directly out of the Government purse with minimal equity from the operators (in the Welsh example at least) but with no bank involvement, whilst the Glasvezelnet project in Amsterdam involved a spread of private investors including the municipality and five[9] housing corporations effectively syndicating the risk, but with no guarantees from the Authority effectively making the investment "as private" so avoiding a State Aid challenge.

If private investors and public money is to truly make the developmental impact that broadband promises, these financing structures will need vision on the part of the Authorities and creativity on the part of the advisers & bankers, and given the overwhelming consensus as to the importance of this technology, we can only hope they pull it off.