



Broadband in the UK: A new infrastructure asset class?

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BT will not have to sell off its Openreach business. Instead, Ofcom (the regulator) has stated that Openreach will become a separate legal entity within the BT group with its own staff, constitution and board of directors (with duties to Openreach, not BT). However, there are still potentially significant changes occurring to broadband connection in the United Kingdom.

But, to dial back slightly, what is infrastructure, what is Openreach, and why is broadband important?

Background: The Broadband Infrastructure Sector

Infrastructure

Infrastructure is the basic physical systems that support an economy, either on a macro or microeconomic scale. Fundamentally, it is the bedrock of economic growth. Broadband hardware is a key aspect of infrastructure but, up until now, investors (including infrastructure funds) have shown relatively little interest in investing in the sector. There are a number of reasons for this previous lack of appetite: from a lack of familiarity with the nature of broadband as an infrastructure asset, through perceived technology risk and to the previously relatively closed nature of the sector.

Now, however, there is a growing opportunity to invest in infrastructure as an asset class.

The Market

Openreach was set up in January 2006 and is the part of BT that installs and maintains the cable and fibre optic infrastructure that provides a significant majority of fixed broadband connections in the United Kingdom (covering 83% of premises).

Fibre optics are glass or plastic cables - as opposed to older, metal cables – which have a higher bandwidth and can transfer data faster and with a lower incidence of interference. 'Broadband' indicates that there is a high data transfer capacity.

Openreach is obliged to provide access to infrastructure to all service providers on the same terms, but a number of BT's competitors complained that there was a clear conflict of interest between Openreach as the infrastructure provider and BT as a service provider, hence Ofcom's aforementioned review.

Why is broadband important?

Installing fast broadband is important as it is essentially a futureproofing strategy. An increasing number of home and business devices are internet-connected (as part of smart networks) and so increased bandwidth facilitates technologically advanced homes and business competitiveness, both domestically and internationally. The government also believes that there will be numerous ancillary benefits to broadband roll-out, including reduced greenhouse gas emissions from a reduction in commuting and business travel.

What's in the speed: Superfast, Ultrafast, Hyperfast

So what are the speeds? Superfast broadband is generally taken to be download speeds in excess of 24 or 25Mb per second (though the EU defines this as 30 Mbps), ultrafast broadband is usually defined as download speeds in excess of 100Mbps and hyperfast broadband is typically determined as download speeds in excess of 1000Mbps (1 Gbps). By way of comparison, the United Kingdom is currently 19th globally for download speeds (with an average of 14.9Mbps in Q1 2016), as compared to the global leader, South Korea (29Mbps) and European leader, Norway (21.3Mbps).

Not just speed: To the cabinet

There is also a distinction to be made between fibre to the cabinet (FTTC) and fibre to the home/premises (FTTH/FTTP). The former only has a fibre connection to a street cabinet (with a metal cable relaying the connection to the premises), whereas the latter has a fibre connection all the way from the telephone exchange to the premises. This matters as FTTP is faster than FTTC (which becomes progressively slower the further from the premises the fibre cabinet is). Openreach's roll-out under the Superfast Broadband Programme (below) is primarily through FTTC installations. However, future broadband delivery is likely to concentrate increasingly on FTTP solutions.

What are the governments targets?

The government's objectives included providing superfast broadband coverage to 90% of the UK (by premises) by early 2016 and 95% by December 2017. It also aimed to provide basic access (2Mbps) for all by December 2015. The government achieved its 90% target in April 2016. The government subsequently increased this target 97% by 2019 (with a suggestion that the gain share from Phase 1 – see below – could fund this).

Initiatives in the Broadband Infrastructure Sector

What is BDUK?

Broadband Delivery UK is a part of the Department of Culture, Media and Sport (DCMS) which promotes the delivery of superfast broadband (and better mobile connectivity) to achieve government targets. The government (combined with funding from local authorities and the European Union funds) allocated £1.7 billion of funding to the Superfast Broadband Programme in two main phases: Phase 1 to provide superfast broadband to 90% of premises (achieved in April 2016) and universal access to 2Mbps; and Phase 2 to extend this coverage to 95% by December 2017. (Phase 3 currently involves testing extension beyond 95%.)

With Fujitsu, the only competitor to Openreach, failing to gain a single contract for Phase 1, Openreach undertook all Phase 1 work (through forty-four local projects – Phase 2 will be undertaken by a minimum of forty-seven projects and alternatives to Openreach, such as Gigaclear, AB Internet and Airband have been awarded contracts). On Phase 1, with uptake in excess of 20%, the gain share claw back mechanism for Phase 1 kicked in and the government has received £129 million (estimated to rise to £250 million) in gain share.

Delivery of Phases 1 and 2 and towards the remaining 5%

Most Phase 1 and 2 projects have been funded through an operator subsidy ('gap funding') model where, subject to state aid rules, the public sector provides sufficient subsidy to make private sector investment cost effective. The European Commission's Guide to High-Speed Broadband Investment outlines a number of alternative models (including direct public investment, public

outsourcing of concessions and community-led initiatives), but it is likely that, given the relative success of the Openreach roll-out and that much of the infrastructure is privately owned, DCMS will continue to favour subsidising operators as the major model for delivering increased broadband speeds.

To this end, BDUK is promoting the Broadband Delivery Framework, whereby BDUK operate and provide governance (including change control) on a framework agreement from which a local body, with local government funding, central government funding and (potentially) EU funding, operates a mini-competition for the successful bidder to supply the tendered solution under a call-off contract (which is likely to last around seven years post-implementation, during which time the revenues of which should be sufficient to pay back the supplier's investment).

Future targets?

In comparison to current UK targets, the European Union (through its Digital Agenda for Europe initiative) intends that superfast broadband will be available to all by 2020 and proposes that ultrafast broadband (5G) will be available by 2025. But the UK government does not appear to be behind the curve (regardless of Brexit). The former DCMS minister Ed Vaizey MP suggested in April 2016 that hyperfast broadband roll-out would become significant between 2020 and 2025. Whereas it can be expected that Openreach's G.fast roll-out and Virgin Media's cable network expansion may bring about up to 70% Ultrafast broadband coverage by 2020 on a solely commercial basis, further public sector investment is needed to meet these future targets. It is these further medium-term targets that provide the immediate investment opportunity.

Broadband Investment Fund

By reference to the 2015 Autumn Statement, the Broadband Investment Fund (BIF) is a fund with the purpose of supporting the delivery of the fast and reliable broadband that a modern, productive economy needs; "Innovative approaches to supporting the market will help deliver ultrafast speeds to nearly all premises."

The government's request for proposals (RFP) for a fund manager has recently closed (8 August) with the purpose of BIF being to invest in businesses operating in the UK broadband sector (including supporting industries such as those associated with training and construction in the broadband sector), increasing the availability of affordable capital and thereby supporting the growth of alternative network developers and stimulating greater competition in the broadband sector.

The government will provide a maximum of 50% of total funds (preferably with increased private sector investment resulting in the government providing a lower percentage) and invest in BIF as a limited partner. The optimum size of BIF is part of the RFP for fund managers and the government has stated that BIF will be operated on a solely commercial basis with the capability to undertake a wide range of investment – from senior

higher yielding debt, through preference equity to ordinary equity. However, it is understood that there is a preference for debt-focused investing so as not to unnecessarily dilute existing equity, though asset class preference was also part of the RFP.

Universal Service Obligation

As part of the government's Digital Economy Bill 2016-17, there will be a universal service obligation (USO) - a legal right to request an internet connection with a minimum 10Mbps download speed by 2020 - though how this will be achieved technologically (essentially for the remaining 3% not covered by the superfast target) is presently unclear (though Ofcom intends to publish a report talking to this by the end of 2016) and, given the recent exponential increase in speeds, there have already been calls for this obligation to be increased to 30Mbps by 2022. Either way, satisfying requests for fulfilment of the USO also provides a (perhaps more niche) investment opportunity.

The Investment Opportunity

Direct and Indirect Investment Opportunities

As evidenced above, there are a number of investment opportunities in the future development of broadband in the UK, many of which will interest infrastructure funds.

Direct investment opportunities include providing debt and equity to companies that construct the network infrastructure (through non-recourse financing, limited recourse financing – further below - or otherwise), for example those alternative network companies that have been awarded contracts for projects in Phase 2 of the Superfast Broadband Programme, and/or provide solutions to the government to facilitate it meeting its future obligations under the USO.

Opportunities around network infrastructure will not end with the Superfast Broadband Programme. That may cease when the 95% or 97% targets are met or it may be extended or replicated to form an 'Ultrafast Broadband Programme'. Either way, network upgrades are inevitable and the government wants to promote an open and increasingly competitive market (as opposed to an Openreach-dominated oligopoly).

Indirect investment opportunities include BIF. This will ultimately involve investing (most likely debt) in companies in the broadband sector on a corporate, as opposed to a project financing, basis. The government will hope that BIF contributes to increasing competition in the sector.

What companies will have to do to attract investment?

Companies looking to submit tenders (under broadband delivery programmes) for future upgrade projects will have to show that they have sufficient funding (and, where applicable, financing) in place to meet contractual obligations, that adequate governance structures are in place, that the tender provides value for money and that

there is an appropriate allocation of risks between the public and private sectors (with risk being allocated to the party best able to mitigate it). As with all targets, but especially regarding the USO, there will also be a significant focus on technological efficacy. Factors such as governance, track-record and contracts obtained to date will be key to those seeking corporate investment from funds such as BIF.

Does broadband as an asset lend itself to project finance?

In our experience, for an asset class to be successfully project financed (i.e. on a non-recourse or limited recourse basis), there are a number of key requirements. These include: (i) a stable and predictable cashflow; (ii) proven technology; (iii) experienced sponsors; and (iv) a robust contractual structure.

The contractual structures can be put in place and sponsors increasingly understand and are interested in the broadband. Further, broadband is a rapidly maturing technology and the risks are being progressively better understood (and can be more optimally allocated and priced). This maturation can be seen evidenced by the EIBs recent £21m investment in alternative network company Hyperoptic.

The key question is, therefore, whether broadband can provide a stable and predictable revenue stream. Our experience is that, for a number of reasons (including regulatory requirements and exclusivity), this is possible but challenging.

Competition and Conclusion

The UK government has highlighted the need, in the short to medium-term, to continue to upgrade network infrastructure to (amongst other reasons) sustain and improve the competitiveness of British business. Openreach has undertaken most of the work so far, but the government believes that exposing it to greater competition (from the likes of alternative network companies such as CityFibre, Gigaclear and Hyperoptic), as well as reform (such as the requirement to act with greater independence from BT) will benefit the sector.

Upgrades are likely to continue to be carried out through initiatives such as the Superfast Broadband Programme and the USO, whilst the government can promote competition in the sector through BIF.

In the longer-term, a competitive internet infrastructure sector in the UK may be able to leverage its experience and provide export opportunities. Procurement and investment structures used in the broadband sector could also be rolled out into the government's international governance initiatives such as the Foreign and Commonwealth Office's Prosperity Fund and various initiatives run by the Department for International Development.

Broadband is becoming an increasingly important asset class and this provides investors with a diverse range of

opportunities. The question is, which investors will take the lead and establish their reputation in the sector?

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