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Ofcom's Strategic Review of Digital Communications

Dear Clive, Brian and Dave,

Thank you to you and your colleagues for meeting with us last week. Following that discussion I wanted to set out clearly Vodafone's position on the UK fixed broadband and telephony markets for the purpose of your ongoing Strategic Review of Digital Communications ("SRDC")

[CONFIDENTIAL]

There is no fit for purpose regulated product today, we have no verifiable data on duct and pole availability and we do not believe BT would be willing to supply such access commercially. All of these significantly increase the execution risks and make it very difficult for any potential infrastructure investor to invest. We remain supportive of regulatory efforts to address these issues and improve regulated access to incumbent passive infrastructure to improve the depth of competition and consumer choice. However, our experience from other countries such as Spain and Portugal suggest that setting up such a regime takes considerable time and there are many key factors which remain unknown today.

Telecommunications is a scale game, nowhere more so than in fixed access networks: overcoming BT's economies of scale, scope and sunk costs, means investment cases will always be very difficult. Therefore, for the purpose of the SRDC we believe that there is little prospect of effective and sustainable infrastructure-based competition in this market within a reasonable timeframe.

The repercussions of this reality are far reaching, as the impact is not limited to consumers, or fixed customers, but the entire industry. The merger of BT and EE has created an



organisation with more than 65%¹ of the UK industry's free cash flow. Rather than a BT that is 'too big to fail', (unlikely given the financial cushion of its SMP services), the risk is that in the future BT/EE will be 'too big to regulate'. BT will continue to control the technology choices, speed of rollout and new product development for the entire industry without any of these decisions being subject to regulatory oversight. As noted by the recent British Infrastructure Group Report, BT *"famously claimed in 2009 that 2.5 million homes would be connected to ultra-fast Fibre to the Premises (FTTP) services by 2012, which is 25% of the country. Yet by September 2015 they had only managed to reach around 0.7% of homes."*² A continuation of current trends means alternative communications providers will be increasingly reduced to the role of mere resellers of BT's wholesale services.

The fundamental problem with the options we discussed to escape this 'single firm investment trap' is that while forbearing from regulating the prices of BT's SMP products-to the level of its efficient costs might encourage long-term alternative investment this is by no means guaranteed and what is more, it definitely creates competition distorting over-recovery by BT in the meantime.³ This distortion itself leads to higher consumer prices, unjustly enriches BT, and prevents alternative operators such as Vodafone from gaining the customer numbers needed to underpin any future infrastructure build case. [CONFIDENTIAL]

Vodafone has put forward two possible ways of squaring this circle:

1. Structural separation of Openreach; or
2. A 'wedge' which ensures that BT over-recovery in SMP products is used for network improvements, particularly passive access; which improves the current functional separation model, by limiting the discriminatory impact of owning Openreach for its downstream retail business units.

We remain of the view that structural separation of Openreach whether via domestic legislation or the 'exceptional circumstances' provision of the Access Directive⁴ in the EU Common Regulatory Framework ("CRF") is the most appropriate means of improving outcomes for consumers, increasing competition and incentivising further fibre investment.

We consider that Ofcom's power, as a national competition authority, to make a market

¹ See Redburn Telecommunications Services "BT Group >£500m Risk to Openreach Cash Flow" 14 December 2015 at p. 12 (attached). Analysis of the parties' public acquisition synergies case suggests this will rise to more than 68.8% within 4 years.

² British Infrastructure Group Report "Broadband- A new study into broadband investment and the role of BT and Openreach" published 23 January 2016 at p. 13.

³ You are already aware of the Frontier Economics analysis for Vodafone which concludes that in the past 10 years BT's SMP services over-recovered more than £6.5bn above its (already generous) cost of capital. Such over-recovery could be dwarfed by a future deliberate policy decision by Ofcom to forbear from regulation to incentivise alternative infrastructure investment.

⁴ See Article 8(3) paragraph 2 of the Access Directive of 7 March 2002 as amended.



investigation reference (MIR) under the Enterprise Act 2002 (EA02) is a separate function to its role under the CRF as a national regulatory authority. The CRF does not preclude Ofcom from having the ability to make a MIR under national law because:

(i) Ofcom's ability to make an MIR under Part 4 of the EA02 is a separate statutory power set out in section 370 in Part 5 of the Communications Act 2003 (CA03). Part 5 of the CA03 sets out Ofcom's role as a national competition authority in relation to communication markets, including its concurrent powers in relation to the Competition Act 1998 as well as its concurrent ability to make an MIR. Ofcom's role as a national competition authority is distinct from its role as a national regulatory authority under the CRF, which is set out in other Parts of the CA03 e.g. Part 2 for networks, services and radio spectrum; and

(ii) Article 1(2) of the Framework Directive states that the provisions of the CRF "*are without prejudice to obligations imposed by national law in accordance with Community law in respect of services provided using electronic communications networks and services*".

Structural separation would enable alternative communications providers as well as the Government to invest in a transparent and efficient way via Openreach⁵ while not allowing a vertically-integrated BT to over-recover on its legacy assets and use that over-recovery to distort competition in downstream and other related markets. We believe appropriate governance arrangements such as the dividend policy under a Shareholders Agreement linked to roll-out KPIs and/or the conditions attached to funding any future broadband Universal Service Obligation could be put in place as part of implementing separation to meet other policy goals such as rural fibre roll-out.⁶

Another alternative is to introduce a 'wedge' in the regulated pricing of BT's SMP products which ensures that it only receives its efficiently incurred costs even if regulated prices higher than this are permitted.⁷ Openreach could be obliged to invest this excess into network improvements which would support greater competition in the future. As set out in the attached note from Redburn:

"Instead of passing Openreach price reductions to operators, excess returns could be used to solve the SME and rural coverage problems Ofcom says it has already identified by building new ducts or fibre access. Another way of looking at this is to

⁵ Vodafone has already made clear that it would be willing to invest in a structurally separate Openreach. <http://www.theguardian.com/business/2015/jul/24/vodafone-shareholder-company-replacing-bt-openreach-fibre-optic>

⁶ Vodafone proposed such mechanisms as part of the Strategic Business Plan to be agreed between the regulator, all stakeholders and the Board of an independent 'NetCo' in its work with Oxera in 2011.

http://www.vodafone.com/content/dam/group/policy/downloads/netco_oxera_final.pdf

⁷ See Vodafone's response to the SRDC dated 8 October 2015 at page 55 and Redburn p. 2



say that there is currently a hidden 'broadband tax' but it all goes to BT; a 'wedge' would redistribute it more rationally."

It is clear that the current BDUK framework has failed in this regard. Vodafone understands that to date, despite the £1.7bn of taxpayer funding, less than 11km of new duct, available for access to competing communications providers under the BDUK state aid rules, have been built.

It is simple to say that the Undertakings are out of date and must be reviewed to reflect the state of the world in 2016, rather than 2005 or that they should be moved onto a preferable legal basis under the CRF. This is certainly true, but is a cause of the problem and not a symptom. The Undertakings (whatever their legal basis) will always lag market developments and BT's plans, precisely because they are designed to fix yesterday's problems and not put in place remedies for tomorrow's markets.

More of the same regulation was found to be inadequate in the last Strategic Review. We urge Ofcom to be bold in this once in a decade Strategic Review and tackle the underlying causes rather than the symptoms of a market which is increasingly dominated by a single incumbent firm.

Yours sincerely,

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