Pre-consultation submission to Ofcom's 2019 BCMR consultation

Joint submission by Colt, Sky, TalkTalk, Three and Vodafone (the 'Passive Access Group')

12 March 2018

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Executive Summary

1. This is a joint consultation response submitted jointly by Colt, Sky, TalkTalk, Three and Vodafone (the 'Passive Access Group' ('PAG')).

2. The PAG was established through the members' shared view that passive remedies are essential to promote competition in business connectivity and access markets. Representing some of the largest providers of fixed, mobile, public and private network operators in the UK, the PAG members are naturally some of the largest consumers of business connectivity products and services (in particular, active circuits) from BT. The PAG therefore makes up some of the most likely users of dark fibre and duct and pole access ('DPA').

3. The PAG is conscious that Ofcom is not planning to consult on the 2019 Business Connectivity Market Review (BCMR) until Summer 2018, which is later than usual. We are concerned this may present Ofcom with some timing challenges. The PAG also appreciates that Ofcom is facing additional challenges related to market definition from the previous BCMR and to do with the changing nature of demand and supply conditions. As a consequence, the PAG believes it is a timely opportunity to provide Ofcom with some thoughts about how it sees the Business Connectivity Market (BCM) evolving in relation to passive access and regulation.

4. We set out our thinking on the following matters in more detail:

   (a) **Market power and SMP**: The PAG begins by pointing to the key characteristics and trends in Contemporary Interface Symmetric Broadband Origination (CISBO) services, and how Ofcom – taking into account the CAT's judgment in the 2016 BCMR appeal – may need to adjust its market definition and market power assessments going forward. The case for a single (bandwidth-agnostic) product market has only become stronger, and the assessment of market power needs to take into account a broader set of indicators of competitive conditions along with the reality that CPs can face significant barriers to competing for a customer even if they have pre-existing infrastructure in the area.

   (b) **Benefits of dark fibre >1Gbit/s**: The PAG continues to consider that an unrestricted dark fibre remedy (usable in any market in which BT has SMP) will best promote Ofcom's duties, enabling a new wave of innovation and investment. We trust this means a dark fibre remedy will be readopted above 1Gbit/s once Ofcom has had the opportunity to assess the markets in which these products are sold again. We are aware Ofcom has a significant amount of data and submissions already on the benefits of dark fibre, through various consultations and litigation. In this section, the PAG summarises and provides references to some of our submissions on the benefits of an unrestricted dark fibre remedy for any market where BT is found to have SMP, including where appropriate for >1Gbit/s services, and an update about some of the benefits that have since been identified.

   (c) **Dark fibre pricing should be cost-based**: More strongly than ever, the PAG considers that it is wrong to not use cost based pricing for dark fibre. Every other significant regulated product is cost-based, and for good reason: cost-based pricing delivers the best outcome for consumers, maximising uptake and leading to efficient competition on the merits.

Ofcom has provided no good reason for departing from an established and proven pricing methodology. We refer Ofcom to the analysis in the PAG's previous submissions which demonstrates that a cost-plus pricing methodology for dark fibre is clearly superior to the current active-minus methodology. We also set out additional reasons that have emerged since, for why cost-plus is a clearly superior methodology.

(d) **Duct access**: The PAG considers that having consulted in two previous BCMRs on duct access and deciding not to impose it, it is not inappropriate for Ofcom to continue to delay the adoption of a duct access remedy. We set out the reasons why an unrestricted duct access is appropriate, which include the evolution of technology, demand, supply and remedies in other markets.

(e) **Cost of capital**: The PAG considers that Ofcom's current approach is out of alignment with the latest regulatory best practice and therefore over-values BT's cost base. This has the knock-on effect of grossly overpricing the remedies Ofcom imposes on BT as a consequence of its SMP. This can have serious impacts on competition and ultimately the prices consumers pay. While the cost of capital proposed by Ofcom in its most recent WLA draft statement is (at least in some respects) a step forward, the PAG submits that Ofcom must update its approach to cost of capital if its approach is to evolve in line with best regulatory practice as demonstrated by other economic sector regulators.

5. This document contains the PAG's initial shared views on matters from the regulation of BT in BCMs, which may be subject to adjustment in the future. Please let us know if there is anything you would like any of the PAG members to elaborate on or if you require further evidence and we would be very happy to arrange for it to be provided.

Market definition and SMP in the next review period

6. Ofcom's approach to market definition and market power in future reviews must be grounded in the changing nature of the business connectivity market. CISBO services are fast evolving with different dynamics to other markets regulated by Ofcom, such as residential broadband markets. In this section, the PAG briefly outline their views about current trends in the market and what this means for Ofcom's market assessment. A more detailed analysis reflecting Vodafone's and TalkTalk's position has been prepared by Frontier Economics and provided to Ofcom.

7. In terms of product market definition, in the last BCMR, Ofcom found a single market for the provision of CISBO services at all bandwidths. While Ofcom's reasoning has been overturned as a result of BT's appeal, the PAG firmly believe that Ofcom reached the correct conclusion – and that this conclusion will become even more indisputable over the coming years:

   (a) Supply-side considerations support finding a single market – CISBO services rely on a common fibre infrastructure, and the costs for suppliers to switch between different bandwidth products (or offer the full portfolio of products if they already offer one product) is minimal. Furthermore, unit costs for equipment at different bandwidths are continuing to converge (and are small relative to the cost of the fibre infrastructure); and there is a growing trend of using higher bandwidth equipment to provide lower bandwidth services; and

   (b) As the PAG has argued extensively, including during the BCMR appeal – any demand-side analysis must recognise that BT's own SMP (and the lack of price regulation on 10 Gbit/s products) allows it to institute a distorting pricing gradient. This gradient makes it more expensive to switch to higher bandwidth services (artificially reducing switching rates) and raises the costs for BT's rivals in downstream markets – constraining them to compete for the highest-bandwidth connections. This is an issue which the PAG is concerned that Ofcom has paid insufficient attention to in the past, especially given the extraordinary margins it has allowed BT to make on CISBO services.

8. Any market definition test must be applied at <u>competitive</u> prices – not by assuming BT's current prices are those that would prevail in a competitive market. This is particularly inappropriate where higher bandwidth services are not price regulated, where the 'basket' form of pricing regulation allows BT to determine its own pricing gradient, and where there is clear evidence that this pricing gradient does not reflect underlying costs and is likely to impact the willingness of customers to switch at higher bandwidths.

9. In terms of the geographic market, Ofcom's approach in the 2016 BCMR appears to be broadly appropriate notwithstanding the methodological concerns found by the CAT. Ofcom should build on that approach to reflect more detail on the drivers of competitiveness (the number of competing networks in an area and the distance to end users), while recognising that the approach must remain pragmatic and will require some degree of "blurring" of areas with heterogenous conditions, based on regulatory judgement, in order to define a smaller set of large geographic markets.

10. In terms of the market power analysis, the PAG feels that the current approach needs to better reflect the incremental costs faced by BT's competitors. In the case of CISBO services, the cost to connect an additional customer can be substantial even over short distances – and so even a close alternative provider may find the cost (and time) to link a nearby customer prohibitive. Competitive constraints on Openreach will therefore be most effective where the specific location is connected to multiple competing networks, suggesting that the share of connections that a provider has in a geographic area is related to the average incremental cost faced and the degree of constraint. A mechanistic threshold (e.g. identifying areas with x number of networks within 100m of a premises) is therefore unlikely to be a good proxy for identifying areas where BT's level of market power is similar. The test for finding a lack of SMP should be carried out separately from the geographic market definition and consider a broader set of indicators of competitive conditions (such as profitability and other drivers of cost for fibre deployment).

11. In the PAG's view, a rigorous analysis of market definition and market power is likely to lead to a broadly similar outcome to Ofcom's initial findings in the 2016 BCMR – with BT found to have SMP in a single product market at all bandwidths, including 10Gbit/s, across the vast majority of the UK. This conclusion would properly reflect observed market realities, such as the extraordinary returns BT has been able to enjoy across CISBO services as a whole. Our comments in the following sections draw from this conclusion and focus specifically on the remedies Ofcom should impose. The PAG looks forward to the opportunity to provide more detail and evidence in relation to all of these issues during the formal consultation phase.

Benefits of unrestricted dark fibre

12. The PAG recognises that Ofcom imposed the current static 1Gbit/s dark fibre remedy whilst it dealt with the issues raised by BT's appeal of the 2016 BCMR and we can understand that decision given the circumstances. However, dark fibre restricted to 1Gbit/s was not Ofcom's original plan (that we supported) and does not go far enough.

13. Dark fibre should be imposed in any market where Ofcom determines that BT has SMP and we would therefore urge Ofcom to impose an unconstrained dark fibre remedy once it has had the opportunity to conduct a new market power assessment including CISBO services above 1Gbit/s. A remedy unconstrained by bandwidth is not only appropriate given the single product market (as described above) but clearly provides the best opportunity for competition on the merits. Since the underlying and fundamental competitive conditions for business connectivity are the same at all bandwidths (and the difference in cost for supplying different bandwidths is not significant), differences in actual competitive conditions are only due to BT's artificial pricing structure. There is therefore no good basis for imposing different SMP remedies based on different bandwidths. A broadly available dark fibre remedy is essential so that CPs and their customers can make long term investment plans using CP dark fibre and serve the UK's growing bandwidth and service needs.

14. Over a number of years, individually and as a group, the PAG has provided submissions to Ofcom and government about the benefits that duct and unrestricted dark fibre access will bring to the UK economy through increased investment, innovation and competition in the UK

communications market. Hyperlinks to the most relevant submissions are provided below, and these should be read as a part of this submission. In this section we provide a short summary of the PAG's submissions on why it considers that Ofcom is justified in imposing a dark fibre remedy that is unrestricted (for use to supply active circuits above, at and below 1Gbit/s when Ofcom makes an appropriate finding of SMP above 1Gbit/s).

15. Given that in the 2016 BCMR Ofcom accepted that the benefits of unrestricted dark fibre were sufficient to impose a dark fibre remedy unrestricted by bandwidth (in the sense it had no cap) we presume Ofcom continues to consider these benefits hold. We note Ofcom's comment:

> *We expect that in future the dark fibre remedy we propose will be the main vehicle for competition for very high bandwidth services.*[1]

16. To save unnecessary duplication, we expect Ofcom would take the benefits of unrestricted dark fibre set out in the PAG's previous submissions into account in the 2019 BCMR - but for the avoidance of doubt we formally request Ofcom do so and for ease of reference attach them to this submission with references and provide a short overview of our previous submissions about the benefits of dark fibre >1Gbit/s.

17. As some of the largest CPs in the UK (and the world), the PAG's submissions are supported by a wide range of empirical evidence, both from the PAG's own experience in the UK and overseas from purchasing passive and active remedies.

18. The PAG continues to be firmly of the view that, while any sort of passive remedy will be beneficial, restrictions on the use of passive remedies are not appropriate and are not sustainable in the long term. Restrictions only serve to reduce passive remedies' overall potential benefits. Any concerns about unrestricted use, which almost exclusively relate to the protection of existing infrastructure operators' business models (such as in relation to BT's charging gradient), have little to do with promoting efficient entry and competition or the interests of consumers and can be dealt with by calibrating the regulatory tools already well known and used by Ofcom.

2013 BCMR and 2013 BCMR PIA Appeal

19. A number of PAG members (and other CPs) made submissions in response to the 2012 BCMR identifying the benefits of passive remedies and requesting Ofcom to impose them, including dark fibre. The submissions of TalkTalk, Colt, Cable & Wireless and Vodafone can be found here.

20. PAG members also intervened in support of Colt (another PAG member) who appealed Ofcom's decision not to impose passive remedies. It is worth noting that EE supported passive remedies and was part of the intervention group which gave evidence on the benefits and demand for passive remedies. The primary legal submissions of the interveners are attached at annex A (we have not included supporting witness evidence or the full suite of submissions including

[1] 2016 BCMR Statement, para 8.195.

confidential material in Annex A, as these should be readily accessible to Ofcom, but we ask Ofcom to review all the PAG's submissions and evidence in full).

November 2014: BCMR preliminary issues consultation on passive remedies

21. In response to Ofcom's consultation November *2014 BCMR preliminary issues consultation on passive remedies,* on 19 January 2015 the PAG provided a detailed response which included a report from Frontier Economics which can be found here. The benefits of dark fibre which the PAG has identified are set out in section 1.

22. In summary, the January 2015 report focussed on the various benefits to innovation. It also outlined the productive efficiency and allocative efficiency that passive remedies bring. These efficiencies arise, in large part, because of the incentives the incumbent faces where there is a lack of competition *vis a vis* the incentives it (and its competitors) face if competition through passive remedies emerges.

May 2015: BCMR consultation in relation to dark fibre pricing

23. In its May 2015 *BCMR: Review of competition in the provision of leased lines* consultation Ofcom proposed to introduce a dark fibre remedy which, in effect, restricted the use of dark fibre to the supply of active circuits at or above 1Gbit/s. On 15 July 2016 the PAG provided a further detailed response to the consultation, including a further report from Frontier Economics. The July 2015 report focussed on the optimal pricing mechanism for dark fibre in view of Ofcom's duties; the report can be found here and the benefits are set out in section 1.

24. The PAG's response to the July 2015 report focussed on the wider ranging benefits from dark fibre that occur from Ofcom imposing a cost-plus pricing methodology due to the fact it would make more of the active circuit market contestable (both above and below 1Gbit/s) from which more of the benefits referred to above would follow.

2016 BCMR appeal submissions

25. PAG members (Colt, TalkTalk, Three and Vodafone) submitted further evidence of the benefits of dark fibre in support of Ofcom in BT's appeal of the 2016 BCMR. The PAG's primary legal submissions to the 2016 BCMR appeal are provided at Annex B (we have not included supporting witness evidence or the full suite of submissions including confidential material in Annex B, as these should be readily accessible to Ofcom, but we ask Ofcom to review all the PAG's submissions and evidence in full). The PAG's submissions on the benefits of dark fibre focussed on the fact that dark fibre gives CPs access to the ability to control, test and manage their own active products end-to-end. This means they do not have to rely on BT's ineffectual and self-serving Statement of Requirements (SoR) process to (not) drive innovation. CPs could then compete to drive critical advancements such as lower latencies, early fault detection, quicker repairs and more secure networks. In particular, the innovations that come with 5G ecosystems will rely on network layer technologies being available through CPs being able to self-supply active circuits.

November 2017: BCMR consultation: dark fibre at 1Gbit/s

26. On 30 December the PAG responded to Ofcom's 23 November 2017 *Consultation: dark fibre* at 1Gbit/s, reiterating that many of the benefits the PAG had already identified in previous submissions, and the evidence it had provided as part of the BCMR appeal remains relevant to Ofcom's proposal to impose dark fibre at 1Gbit/s.

27. In its response the PAG emphasised that while it understood Ofcom's decision to impose dark fibre at 1Gbit/s in light of the BCMR appeal judgment, in view of the growth in demand for bandwidth and requirements of 5G networks this restriction was not sustainable. If Ofcom wants to promote CPs to invest in their networks to meet medium to long term demand, taking into account practicalities such as the reality of long term customer contracts, Ofcom should remove the restrictions on the use of dark fibre at the earliest opportunity.

28. In the absence of being able to use dark fibre to provide active circuits above 1Gbit/s for access and backhaul networks, the majority of the ever-increasing bandwidth demands of UK citizens are unlikely to be met. UK communications networks are unlikely to be in a position to meet the demands of the future including in particular the fixed access segment demands of 5G architecture.

Dark fibre pricing should be cost-based

29. The PAG considers that a cost-based pricing methodology for dark fibre is the only correct approach to meet Ofcom's objectives and duties. The PAG provided compelling evidence including economic evidence to support this conclusion in its July 2015 submission report by Frontier economics found here and in its submission cover document found here.

30. However, in the April 2016 Statement, Ofcom decided that the appropriate pricing methodology to apply to dark fibre should be active-minus based i.e., derived by deducting those costs which are not incurred (avoided) by BT in providing equivalent DFA, being essentially the costs of active network elements and non-domestic rates from the price of BT's 1Gbit/s Ethernet products.

31. This approach is, in the PAG's view, unsustainable. Every other significant regulated product is cost-based, and for good reason. Cost-based pricing is well established and is broadly accepted to deliver the best outcomes for consumers, maximising uptake and enabling efficient competition on the merits. Ofcom has provided no good reason for departing from this established and proven pricing methodology.

32. In other contexts, the perverse consequences of using active minus pricing would be clear. For example, it could not sensibly be suggested that Ofcom should have capped the price of LLU services based on the speed of the line and the corresponding retail service. It is apparent, having seen the benefits of competition and investment which arise from cost-based pricing, that such a pricing approach for LLU would have created far fewer benefits for consumers. The same is clearly equally true for business connectivity services, albeit that as a new remedy, the way in which active minus pricing holds back competition will not be immediately evident.

33. If Ofcom wishes to deviate from a cost-plus methodology (with the consequence that the remedy is restricted to only part of the total business connectivity market) it needs a compelling reason to do so. To date, the primary reason relied upon by Ofcom is the preservation of BT's existing pricing structure – without any supporting evidence demonstrating that maintaining this pricing structure is efficient or in consumers' interests. The current price structure can be assumed to be profit-maximizing for BT, and is likely to reflect (for example) that 10Gbit/s services are not currently price regulated, and that BT therefore has an incentive to design its pricing gradient to maximise BT's ability to maximise profits at 10Gbit/s. It is important that, rather than continue to rely on assumptions that BT's pricing is efficient to justify active-minus pricing, Ofcom properly analyses BT's incentives and the competitive effects of its pricing choices.

34. In the last BCMR, Ofcom's assessment criteria to determine the appropriate pricing methodology was by reference to a 'Harvey-ball' qualitative analysis set out in the final statement. As you will recall (or see) Ofcom's analysis appeared to be finely balanced, with the scales tipping in favour of active minus, effectively, 14 points to 16. The balance was tipped because Ofcom considered that active-minus scored better on ease of implementation, compatibility and allocative efficiency.

35. We agreed with Ofcom that cost-plus scored significantly better than active-minus on productive efficiency, dynamic active and risk of gaming.

36. However, the PAG demonstrated, with the help of Frontier economics, why it strongly disagreed with Ofcom's assessment that active-minus was superior to cost-plus, on dynamic infrastructure investment, active compatibility and ease of implementation.

37. On dynamic infrastructure investment, Ofcom's rationale seemed to focus on maintaining the tariff gradient, however, BT has no incentive (or ability) to set Ramsey efficient prices mainly because it has broader strategic objectives (and in any event lacks the relevant information to achieve Ramsey efficiency). Ofcom's reasoning for maintaining the high premia for very high bandwidth services (i.e. to enable other infrastructure operators to enjoy space to compete) did not stack up, in view of the fact Ofcom should not be protecting particular businesses and pricing models – instead, Ofcom's duty is to support sustainable infrastructure investment in the long term.

38. On active compatibility, if Ofcom used a cost-based approach it would have a consistent approach between active and passive pricing, as it does for LLU and WLR, which would help prevent the risk of inefficient entry due to the differences in the recovery of common costs. Further, active-minus introduces inconsistencies between pricing at different levels of the value chain which will become unsustainable in the longer term. On ease of implementation the need for Ofcom to set active minus price by reference to BT's annually derived LRIC appears to require far more resources than a simple forward-looking charge control. The cost-based control would also require less monitoring and likely involve fewer disputes.

39. In view of the above analysis, our assessment using Ofcom's 2016 BCMR methodology is that a cost-plus methodology is far superior to active minus, scoring 22-12.

	Ofcom's assessment		Frontier's assessment	
Criterion	**Cost based**	**Active minus**	**Cost based**	**Active minus**
Allocative	0	2	0	1
Productive	4	2	4	2
Dynamic – Active	4	2	4	2
Dynamic – Infra	0	2	3	2
Active compatibility	0	2	3	1
Gaming Risk	4	2	4	2
Ease of implementation	2	4	4	3
Total	14	16	22	12

Source: Adapted from the Frontier report, adapted from Table A26.8, BCMR May 2015

40. However, the PAG took consolation from Ofcom's statement where it said:

> *We would therefore expect that the next price control review would need to reconsider whether to continue with an active minus reference price approach (and if so what that reference product and price should be), or whether to move to a more cost-based approach.* A26.158

41. As set out in the PAG's response to the November 2017 dark fibre at 1Gbit/s consultation response (paras 74-85) the PAG maintains that active-minus pricing suffers from serious deficiencies and that a cost-plus methodology is preferable. The case for a cost-plus methodology has only strengthened since Ofcom's May 2015 statement.

The NDR Appeal

42. TalkTalk's appeal of Ofcom's Non-Domestic Rates decision illustrates the implementation problems with active minus pricing, and why such pricing does not properly meet Ofcom's objectives. This is in large part due to the way that the Valuation Office Agency's NDR system works i.e., the entity that lights the fibre pays the NDRs. As a consequence, Ofcom's original active-minus methodology proposal, which would price dark fibre based on the equation *"[x]Gbit/s active price minus avoidable LRIC minus BT's NDRs"*, created an unequal playing field as BT pays far lower NDRs than other CPs. Therefore, the cost to CPs of lighting fibre when they pay their NDRs will therefore be much higher than BTs' costs (as a result of BT' small 'minus' for the NDR portion in the active minus calculation).

43. As a result of TalkTalk's successful appeal against Ofcom's methodology, the new NDR methodology better enables competition using dark fibre in the way Ofcom had originally intended, but it still has to use a number of assumptions about CPs' networks and how they will use dark fibre – assumptions which will not always reflect how CPs are, or will want to, use dark fibre. This is, clearly, still imperfect.

44. However, a cost-plus based methodology does not suffer from the same implementation problems. This is because under a cost-plus methodology the regulated price set by Ofcom is

based on BT's cost stack (which will not include NDR costs of lighting fibre) rather than BT's voluntary pricing choices for active fibres (where BT has paid NDRs).

45. As a result, the current methodology Ofcom uses to reflect NDRs in the dark fibre price continues to be imperfect and to create implementation problems. This should provide a further strong incentive for Ofcom to adopt a cost-plus methodology and add to the case that active-minus is not appropriate to use for dark fibre.

46. Ultimately Ofcom's principal duty requires it to adopt the methodology that promotes more competition, has fewer implementation issues, and ultimately lowers prices to all consumers. A cost-plus methodology significantly outscores an active-minus methodology overall. A cost-plus methodology is superior after taking into account dynamic, allocative and productive efficiency. Using a consistent bottom-up cost model, as Ofcom does for LLU and WLR, Ofcom can easily implement a cost-plus methodology and ensure consistent prices across active products and prevent inefficient entry. There is no danger to BT's recovery of costs with an appropriately calibrated cost-plus methodology and it will be easier for Ofcom to monitor.

47. In view of forecast migration to higher bandwidths and if Ofcom proposes to impose an unrestricted dark fibre remedy (by bandwidth), which it must, then Ofcom should not continue to shelter either BT's common costs in the <1Gbit/s markets nor inefficient high bandwidth infrastructure operators.

48. We would be happy to discuss this with you and potential cost modelling approaches if that would be of assistance.

Unrestricted cross market duct access (UCMDA)

49. Duct and pole access are increasingly critical for operators seeking to deploy modern, high capacity networks capable of delivering the requirements demanded by new-generation networks, in particular 5G. The PAG has provided a number of submissions at each relevant opportunity supporting the introduction of duct and pole access:

    (a) The PAG's response to the 2016 BCMR preliminary consultation: passive remedies and main consultation response included a cover document and two consultant reports stating that Ofcom should impose a duct access remedy on BT, as a complementary remedy to dark fibre.[2]

    (b) The CP Group intervened in support of CityFibre's ground in the BCMR appeal that Ofcom should have also imposed a duct access remedy.

50. In view of this, the successful introduction of DPA by other NRAs in the EU and further afield, legal developments at the European Commission level and the evolving regulatory and

[2] https://www.ofcom.org.uk/__data/assets/pdf_file/0024/53547/passive_access_group.pdf; https://www.ofcom.org.uk/__data/assets/pdf_file/0019/41572/pag.pdf https://www.ofcom.org.uk/__data/assets/pdf_file/0015/51054/pag_annex_a.pdf; https://www.ofcom.org.uk/__data/assets/pdf_file/0026/51578/pag_annex_b.pdf

commercial structure and demands of the UK communications market, the PAG does not consider it appropriate for Ofcom to continue to delay introducing a DPA remedy in the 2019 BCMR. The PAG makes the following points in support of a DPA proposal.

Objectives for UK communications markets

51. Government is determined to stimulate private investment in 'full-fibre' connections, expand coverage beyond 95% of the UK and seeks to be a world leader in 5G.[3] To assist with this government has offered 100% business rates relief on 'new fibre'. Government recognises:

> *The transition from copper to full fibre networks across the UK is necessary to future-proof the speed, capacity and reliability of fixed connections, and create the backbone of 5G mobile networks.*

52. Government notes:

> *Whilst the UK is an international leader in the availability of copper-based super-fast broadband it must improve its performance on the deployment of full fibre networks, to support the connectivity of homes and businesses and provide the backbone for a denser 5G mobile network and underpin economic growth.*[4]

53. In its DCR initial conclusions Ofcom committed to:

> *…make it easier for competing providers to build their own fibre networks, across as much of the UK as is practicable, by providing them with access to Openreach's network of underground ducts and telegraph poles.*[5]

54. Ofcom and government clearly recognise duct access as necessary to promote fibre roll out in the UK. Yet in the DCR conclusions and WLA market review proposals Ofcom proposed restricting DPA to residential premises unless any business rollout demonstrably includes '*rollout to residential consumers at scale*'. This approach seems unlikely to achieve Ofcom's and Government's FTTP objectives any time soon.

55. Ofcom must not second guess CPs' business cases and should permit market players to decide whether to use DPA for residential or business uses on their own. In this respect, regulation should put BT and its competitors on an equal footing. Industry must have the freedom to innovate with respect to their investment decisions and business cases in much the same way they must be left to innovate when Ofcom introduces new access products. Trying to guess the appropriate shape or structure of the market can have unforeseen consequences. It could for example foreclose entry for CPs who may want to serve business customers initially but, once rolled out in an area, see the opportunity to serve consumers. Similarly, it could prevent a CP that initially only serves businesses from entering the market, even though that CP might subsequently become a major competitor for both businesses and consumers.

Regulatory environment

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[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/669136/20171218_-_FTIR_call_for_evidence.pdf

[4] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/663060/Future___Telecoms___Infrastructure___Review-___terms___of___reference.pdf

[5] DCR section 4.

56. Ofcom specifically consulted on imposing a duct remedy but ultimately decided not to do so in its 2016 BCMR Statement, promising to re-consider this in the next BCMR in light of changes in the market (including changes in the WLA market and as result of the impact of the CID/ATI Regulations). The European Commission noted Ofcom's undertaking to review this particular decision in its Article 7(3) letter.

57. As far as the PAG is aware, there has been no use of the CID/ATI Regulations to obtain access to duct. This is not because there is no demand for duct access but because, for all the reasons previously identified, the CID/ATI Regulations provide none of the certainty required for CPs to build a business case based on duct access. As such they remain ineffective, unused and so Ofcom and government can place no store in the CID/ATI Regulations providing a useful substitute for SMP regulated access to BT's duct and pole network.

58. Though Ofcom has already faced two appeals of its decision not to impose duct access in two consecutive BCMRs (which the PAG has intervened in against Ofcom each time) it must have serious concerns as it would not be able to do so a third time, given recent developments.

59. The European Commission was scathing of Ofcom's decision not to impose a DPA remedy in its Article 7(3) letter, going so far as to say:[6]

> *The Commission does not in fact share OFCOM's assertion that imposing universal duct access would create undue implementation risks (related to correct price differentials along the value chain). The latter risks could, in view of the Commission, be mitigated by the use of a uniform costing methodology with consistent asset valuation along the value chain, in line with the approach already adopted for pricing of dark fibre in relation to the 1 Gbps active product.*
>
> *Therefore the Commission asks OFCOM to consider imposing universal physical infrastructure access (to ducts and poles) in the non-competitive areas.*

60. The new European Electronic Communications Code (CRF replacement) includes requirements on NRAs to consider passive infrastructure remedies first in their regulatory toolkit instead of treating them as an ancillary remedy. This means that NRAs will be required to introduce passive access obligations as a standard SMP remedy, in order to deal with the root of competition problems, instead of creating 'regulatory-managed downstream competition'[7] which fails to unleash the types of innovation that are possible in markets that are genuinely competitive.

61. The European Commission has identified the introduction of the European Electronic Communications Code as a priority and it is expected for June 2018. No transposition date has yet been set and it is possible that it may take 12 months from the date that the Code is introduced at an EU level.

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[6] https://www.ofcom.org.uk/__data/assets/pdf_file/0027/76374/ec-comments-on-draft-bcmr-statements.pdf

[7] See, eg, Jon Stern, 'Developing Upstream Competition in the England and Wales Water Supply Industry: A New Approach' (CCRP working paper 17) https://www.city.ac.uk/__data/assets/pdf_file/0018/81027/stern_developing_upstream_competition.pdf.

62. BEREC has identified access to physical infrastructure as the number 1 priority for its 2018 work plan and is looking to establish a common approach and clear guidance on the approach to include access to physical infrastructure in market definition.[8]

63. While it is unclear how the new Code will be reflected in domestic law and Ofcom's participation in BEREC post-Brexit, no one could seriously argue that the UK should turn its back on these EU level developments, which are likely to leave the UK as an ever further outlier in the availability of passive remedies.

WLA DPA

64. Ofcom is proposing to introduce a restricted DPA remedy in its WLA market review from April/May 2018. In view of this, it seems that the next BCMR would be the appropriate time for Ofcom to introduce DPA in the BCMR and 'unrestrict' WLA DPA for cross market business use for a number of reasons.

    (a) It is well recognised that maintaining the regulatory 'split' between BCMR and WLA market remedies becomes increasingly artificial as Ofcom regulates deeper into the infrastructure layers. Allowing cross market unrestricted DPA would free Ofcom to develop a single duct cost model that it can adjust in a targeted way to achieve different objectives in each market.

    (b) Business connectivity markets and fixed access markets are increasingly converging due to the roll-out of FTTP networks, which replicate many of the features of leased lines over an access network.

    (c) Much of the detail as to how BT/Ofcom will effectively restrict WLA DPA from being used in BCMs has yet to be worked out. Whatever Ofcom finally determines, 'policing' restrictive DPA use will inevitably involve cost to Ofcom, BT and industry which consumers ultimately bear.

    (d) Once DPA gets up and running in the WLA market, it seems likely that there will be significant cross market synergies and economies of scope and scale efficiencies from allowing CPs to use duct to serve consumers and businesses in access and business markets. For example, there are likely to be significant benefits to a company like Vodafone from being able to fully self-supply its own fibre for mobile backhaul, business customers and fixed access links.

    (e) Unrestricted cross market DPA will open up possibilities to companies that have only ever served business markets to consider serving residential consumers, if the environment suited it.

65. As is plain, the reasons for introducing unrestricted cross market duct access are compelling. The PAG urges Ofcom to move with the times and the weight of evidence and introduce unrestricted cross market duct access.

[8] http://berec.europa.eu/eng/document_register/subject_matter/berec/download/0/7528-berec-work-programme-2018_0.pdf.

66. In relation to cost recovery, the PAG emphasises that Ofcom should periodically review any impact of introducing UCMDA and ensure that costs remain appropriately allocated between access markets – be they markets for passive or active products, business and local access markets, and for regulated or unregulated products.[9]

67. As a group of communications providers including mobile only operators (H3G), business only operators (Colt), mainly fixed access only operators (Sky and TalkTalk) and a fixed and mobile operator (Vodafone) the PAG would be pleased to meet with you to discuss the opportunities that unrestricted cross market duct access could bring.

[9] We note that there would be various ways to achieve this, including through differentiated pricing for local access and business connectivity usage of PIA. Such an approach has been adopted in other European countries such as France.

Cost of capital

68. Ofcom's approach to calculating BT's cost of capital is neither aligned with the approach which is currently being adopted by other regulators, nor is it close to current market data. As such, it appears to be materially flawed.

69. We recognise that in the current draft WLA statement, Ofcom has reduced the real risk free rate from 0.5% to 0% to reflect continuing decreases in yields on RPI-linked gilts. However, other changes are less beneficial, such as increasing the equity risk premium from 5.5% to 6.1%,[10] and mean that the overall real vanilla WACC acknowledged by Ofcom is 3.7%.

70. This remains significantly higher than the cost of capital determined by other regulators. In its 13 December 2017 decision document, Ofwat said:

> *Our initial view of the cost of capital – based on market evidence – is 3.4% (on a real CPIH basis). In RPI terms it is 2.4%, which is a reduction of 1.3% from the 2014 price review. The effect of this change alone should lower bills of an average water and wastewater customer by about £15 to £25*.

71. Furthermore, Ofcom should be aware of Ofgem's recent proposal in the RIIO2 price controls to significantly reduce the cost of equity to its lower ever level. Ofgem stated in its 7 March 2017 press release and the associated consultation documents that:

> *To make sure the cost to consumers is as low as possible, we are proposing the lowest rate ever for the amount we think energy network owners need to pay their shareholders (3% to 5%) for raising this money (called the 'cost of equity').*

72. Getting this right could make a substantial difference to the price of regulated inputs that CPs must pay. The difference between Ofcom and other regulators is now significant in many cases and many of the reasons Ofcom has been providing for its current approach to assessing BT's cost of capital are no longer being applied by other regulators.

73. If Ofcom aligns its approach to cost of capital with that proposed by the CAA, Ofwat and Ofgem there may be some prospect of also reducing the cost of equity.

74. Given the potential impact that small changes in Ofcom's assessment of BT's cost of capital can have on regulated prices for access products the PAG considers that such 'misalignment' with current best practice in assessing cost of capital can have serious distortionary effects on competition, the prices that consumers ultimately pay and consequently cause Ofcom to fail to discharge its duties.

[10] 2018 draft WLA statement, para A20.6, https://www.ofcom.org.uk/__data/assets/pdf_file/0020/111539/Draft-statement-annexes-17-27.pdf.