Zayo's response to the

Business Connectivity Market review

and the

Regulatory Financial Reporting Consultation

January 2019

Contents

1 Introduction

1.1.1 Zayo Group is the global leader in communications infrastructure, including fibre and bandwidth connectivity, colocation and cloud services to the world's leading businesses. Zayo's high performance fibre network and strategic partnerships provide access to key international markets in 25 countries. Zayo was founded in 2007 and is headquartered in Boulder, Colorado, with European headquarters in London and Paris.

1.1.2 Zayo's UK fibre optic network spans more than 600,000 fibre miles and connects over 130 data centres via routes including alongside national gas pipelines and within London's sewer system. Zayo provides many customers with dedicated fibre connections utilising a combination of on-net, new construction and off-net leased fibre. Zayo extends its network to customer premises principally with self-installed new-build fibre as well as purchased and leased dark fibre.

1.1.3 Zayo is a member of the Infrastructure Inventors Group (IIG) and has contributed to the responses to these consultations submitted by the IIG and is in full agreement with the contents of the IIG submission.

1.1.4 This individual set of responses, therefore, does not repeat points made in the IIG submission. Issues covered in this response are in addition to those in the IIG submission.

2 Executive Summary

2.1.1 In this submission, Zayo comments on two separate, but closely related, Ofcom consultation documents, namely:

- The Business Connectivity Market Review (BCMR); and
- The Regulatory Financial Reporting (RFR) consultation.

2.1.2 The two responses are clearly labelled and are included in this single submission at the have the same deadline[1] and for ease of cross-referencing between the three.

Summary of Zayo's BCMR response

2.1.3 Zayo welcomes Ofcom's approach in the BCMR, with the very clear change in focus from delivering low price access to BT's infrastructure to encouraging effective and sustainable competition through investment in competing fibre networks.

2.1.4 Within the package of proposals set out in the BCMR, there are still components which Zayo considers would detract significantly from Ofcom's stated objective to encourage investment in fibre infrastructure. They are:

- The way Ofcom has defined the high network reach (HNR) market, which Zayo believes results in a market definition that is not consistent with guidelines for market definition, and Ofcom's decision to not impose the leased lines charge control (LLCC) on the HNR;
- Ofcom's assertion that competition conditions for the provision of mobile backhaul (MBH) services are like those in other contemporary interface (CI) access services and that no specific competition concerns arise for MBH services;
- That Ofcom believes its proposed LLCC will provide stable and transparent pricing conditions for the period covered by the review, whilst our analysis shows clearly that this is not the case; and
- The absence of any analysis of and remedies to prevent the possibility of BT engaging in anticompetitive pricing behaviour.

Summary of Zayo's RFR response

2.1.5 Zayo is disappointed to see Ofcom's proposals for a reduction in the level of data disaggregation that BT would need to publish. Zayo believes that the proposed reduction would lead to an increased information asymmetry and less informed contributions from operators to Ofcom's consultation processes.

3 Zayo's response to the BCMR consultation

Introduction

3.1.1 As a provider of high-quality point-to-point fibre connections primarily for the BCM, Zayo considers the BCMR to be one of the most critical regulatory activities in the UK. The wholesale products mandated through regulation and the pricing of those products shape the market as most clients use BT products and pricing as the benchmark for selection of electronic communications services providers.

3.1.2 For Zayo's general view of Ofcom's proposals in the BCMR, Zayo refers Ofcom to the points made in section 3.1 of the IIG response.

3.1.3 Whilst Zayo welcomes most of Ofcom's proposals in the BCMR consultation, it has some specific concerns:

- That Ofcom is prematurely de-regulating in HNR market, which Zayo believes have been wrongly defined;
- That Ofcom is introducing a dark fibre remedy in the inter-exchange connections (IEC) market, at the same time as introducing national DPA through the PIMR consultation;
- That the dark fibre remedy is priced at a level that cannot be replicated by efficient providers using the DPA remedy; and
- That Ofcom makes no effort to identify where BT could behave in an anticompetitive manner (including in pricing) and identifies no remedies to prevent this from happening;

BCMR product and geographic market definitions for CI access services

3.1.4 Zayo refers Ofcom to the relevant sections in the IIG response.

3.1.5 Contemporary interface (CI) access services (BT's EAD-family of products) constitute the vast majority of the BCM for which BT faces competition, and is therefore the main focus of our analysis and response.

3.1.6 As the purpose of defining relevant markets is to determine where a provider may have significant market power (SMP), Zayo takes extreme interest in Ofcom's approach, analysis and proposals in this area.

3.1.7 Overall, Zayo considers that Ofcom's approach has been thorough and that the resulting product and geographic markets proposed are a reasonable representation of the competition conditions in the UK for CI access services.

Mobile backhaul circuits

3.1.1 Ofcom proposes that CI Access circuits used for mobile backhaul (MBH) form part of the overall CI Access market and there is no separate product market. Zayo agrees with this conclusion. However, Zayo would like to draw Ofcom's attention to the consequences of apparent behaviour of BT Wholesale in the pricing and structure of its MBH services, that causes the competitive situation for the provision of mobile backhaul circuits to be different from those of other leased lines services.

3.1.2 In paragraph 4.5 of Volume 1 of the BCMR, Ofcom states that "*although there are some differences between purchasers of mobile backhaul and enterprise customers, in both cases, competition is determined by the proximity of rival networks to the customers site*." Zayo does not agree with that statement.

3.1.3 From participation in a number of tender processes to provide MBH services (either dark fibre or lit high capacity leased lines), Zayo's experience is that mobile network operators (MNOs) are only in a position to purchase MBH services from a new supplier if that supplier is able to provide MBH services across a very large portion of the MNOs footprint. The intelligence Zayo has been able to gather to understand the rationale for that position is that BT's (and potentially Virgin Media's) contract make it extremely difficult for MNOs to diversify their MBH supply without suffering significant adverse financial consequences.

3.1.4 In its Decision on the merger between BT plc and EE, the Competition and Markets Authority (CMA) investigated the MBH market and the impact the merger could have on the ability of competitive providers, such as Zayo, to provide MBH services to MNOs and concluded that:

"For all the MNOs, durations and volume commitments in existing contracts with BT Wholesale make large scale switching difficult in the short to medium term"[2]

3.1.5 The CMAs conclusion points to there being significant duration and volume commitments in the BT Wholesale contracts with MNOs for the provision of MBH services. Feedback from our customer-facing staff confirms that the BT Wholesale pricing and contractual terms appear to constitute a significant obstacle to mobile operators being able to source MBH services from competitive providers

3.1.6 This apparent pricing strategy prevents Zayo from competing for MBH, but also has a more significant effect on competitive investment. A market entry strategy of alternative infrastructure providers is to find an "anchor tenant" in a town or city. This anchor tenant provides the security to invest in a town and the customer base to allow the alternative operator to take the risk of market entry in a given location. Zayo has extensive experience of using mobile operators as anchor tenants in the US, but is not finding it possible to replicate that model in the UK. Zayo believes it is BT's pricing and contractual terms that is preventing Zayo from repeating in the UK what it has successfully done in the US.

3.1.7 Ofcom has the powers to undertake a full investigation of this behaviour and to determine if BTW is behaving in a manner that forecloses competition, as suggested by the CMA and as

[2] CMA op cit Para 17.29

experienced by Zayo. Zayo is only able to provide circumstantial evidence of this behaviour as Zayo does not have access to details of BTW's pricing structure.

3.1.8 However, Zayo notes that CityFibre's experience in Hull shows that where BT does not operate it has been able to provide MBH on a competitive basis to MNOs.

3.1.9 Zayo proposes that Ofcom should undertake an investigation of BT's pricing strategy in MBH, bearing in mind that BT Group plc is the regulated entity and not Openreach. In the event that Ofcom finds that BT's pricing may be deterring competitive entry, then Ofcom should consider ex ante remedies. The IIG's initial suggestions for possible ex-ante remedies include:

- Prohibition of linked sales (in that the sale of access circuits to MNOs is linked to the sale of the core network service);

- Prohibition of national purchasing schemes, in particular prohibition of purchasing arrangements that cross the different regulatory markets as defined by Ofcom.

3.1.10 Zayo believes this a complex issue and it is possible that other remedies will achieve the same end; Zayo is open to engaging with Ofcom in the necessary analysis.

Defining high network reach markets

3.1.11 Zayo does, however have some specific concerns (as also explained in the IIG submission), that Ofcom's use of a coverage measure of 65% (meaning that an area is covered by an operator if that operator can reach 65% of business premises within the specified dig distance (50m), significantly overestimates the size of the high network reach (HNR) market.

3.1.12 Zayo builds new fibre networks in competition with BT (and other operators). In many cases, Zayo will sell one or more initial connection(s) in a new area which cannot provide the required financial return within a reasonable period of time. This is done because Zayo has assessed that there is sufficient business potential in the relevant area for Zayo to be able to win additional business that will make the overall investment in the area financially viable.

3.1.13 During the period between connecting the first few customers and having connected a sufficient number of customers for the area investment to pay back, Zayo would be most vulnerable to BT pricing its services at a level that would make it impossible for Zayo to compete. Not being able to connect additional customers, would effectively result in stranded investment that will never provide a reasonable rate of return.

3.1.14 By deploying the 65% threshold (as opposed to the 90% threshold used in previous BCMRs and also used in other countries, including Ireland), Ofcom is overestimating the amount of actual competition that exists in the relevant geographic locations and could do irreparable harm to investment in new fibre networks. The leased lines market is characterised by purchase cycles of between three and seven years[3], meaning that presence in a location does not mean that competition is yet established in that area. When presence is measured as being able to reach only 65% of customer sites, then it can be assumed that the competitors

[3] As opposed to other services such as broadband services which typically have one or two year purchasing cycles.

present are not yet established and still extremely vulnerable to pricing (and other) tactics by BT.

3.1.15 It is interesting to note that, of all the measures and parameters used by Ofcom in the much-disputed 2016 BCMR Statement, the 90% threshold was disputed by neither BT nor its competitors. Ofcom offers no justification for why it uses the 65% threshold, nor any rationale for the change from using 90% in the 2016 BCMR to using 65% in this consultation.

3.1.16 Ofcom's Strategic Policy Position of July 24th 2018 sets out clear objectives of maintaining and strengthening incentives for investment in new fibre networks, for BT AND competing providers, and it is Zayo's strongly held view that the application of the 65% coverage threshold for defining separate geographic markets (the HNR markets) is in direct conflict with those objectives. Zayo urges Ofcom to reconsider this measure and to instead reintroduce the 90% threshold.

3.1.17 It is Zayo's view that Ofcom needs to either revert to the established 90% reach threshold, in which case it would likely be proportionate to not impose a charge control, or retain the 65% reach threshold, but in that case, it is our view that it is not appropriate for the LLCC to not be applied. It is clear that BT's market share in a market defined using the 65% reach threshold will be substantially higher than in one defined using the 90% threshold. Zayo notes that BT's market share is between 50% and 60% in the HNR areas[4] (outside the CLA), which supports Ofcom finding that BT has SMP in the HNR areas, but we also believe that it a market share at that level does not justify the removal of the LLCC remedy in those areas.

3.1.18 Zayo understands that the SMP assessment is undertaken separately from the definition of geographic markets, but the parameters used to define the geographic market determine whether it the geographic market defined is likely to be characterised by effective competition or not. As set out above, it is our view that a geographic market defined using the 65% reach threshold is unlikely to be either sufficiently homogenous in itself to be a relevant market, nor sufficiently different from the surrounding areas to set it clearly apart from those areas.

CI access SMP analysis

3.1.19 Zayo agrees with Ofcom that BT has SMP nationally, outside the CLA and Hull, and agrees that the new connections data used by Ofcom to calculate service shares is more appropriate that the full inventory data. It also seems clear that the 2016 BCMR decisions relating to SMP and appropriate remedies were made using incorrect data as the inventory data was also distorted for that period.

3.1.20 In order that the current and future regulatory decisions for the BCM are as robust and fact-based as possible, Zayo believes that Ofcom should undertake spot-analysis as well as ensure that record-keeping and reporting from all major providers is improved to provide accurate inventory data to form the basis for the 2021 All Access market review, which Zayo understand is about to start.

[4] See Table A12.15 in Annex 12 to the BCMR.

Product and geographic markets for IEC products

3.1.21 Zayo has no comments on the definition of these markets other than those made in the IIG response section 6.

4 BCMR remedies

4.1.1 Zayo refers to the IIG submission section 7 for comments on remedies that are not specifically discussed below.

Dark fibre remedy

4.1.2 Zayo is not, in principle, opposed to the introduction of a regulated dark fibre (DF) remedy. DF should, however, only be introduced when the most upstream remedy (DPA) has been proven to not be effective.

4.1.3 Ofcom's proposal is to introduce DPA and DF simultaneously for the BT-Only IEC market.

4.1.4 Zayo is also very concerned that BT Openreach will become the provider of DPA, DFA and active CI Inter Exchange circuits in the same geographic areas. In our view this is contrary to the principles of Functional/Legal Separation and Equivalence of Input. The purpose of separation is to remove the incentives for BT to discriminate against its downstream rivals in favour of its own downstream business. By removing these incentives all operators in downstream markets should be able to compete on a level playing field with BT. For this reason, the most upstream assets were placed in Openreach and Openreach did not sell services in competition with its own customers.

4.1.5 However, by introducing both DPA and DFA in the same geographic markets, both sold by Openreach alongside wholesale active CI circuits, Ofcom has completely reneged on the purpose of Openreach. Clearly if Openreach is selling DFA or active CI in competition with its own customers, it has the same strong incentives to discriminate against those firms that BT was found to have discriminated against in the 2005 Telecoms Strategic Review that led to the creation of Openreach.

4.1.6 Ofcom led the world in creating the functionally separate Openreach: a model that has been followed in countries such Italy, New Zealand, Singapore and Sweden. The effect of this separation in the market was strong and clear, as firms that were concerned about being harmed by BT began to invest. Zayo is therefore very concerned to see Ofcom apparently reversing the process and effectively making Openreach a vertically integrated entity providing services at all levels of the value chain in competition with its own customers.

4.1.7 In our view, Ofcom should ensure that Openreach should not become vertically integrated and that it sells products only at the deepest level of the network that is viable in each geographic area. All other downstream products should be sold by a downstream business unit that is not part of Openreach.

4.1.8 Zayo recognises that BT Wholesale does not purchase DPA in the same way that a third party operator would. However, it is fundamental to EOI that all CPs, including BT, buy Openreach services on exactly the same term etc. as each other. However, to ensure fair competition in downstream markets it is important that at least a virtual sale of DPA takes place between Openreach and downstream business units.

4.1.9 Zayo believes that Ofcom is committing a significant error in proposing the introduction of DF from BT-only exchanges. Ofcom's Strategic Policy Statement (July 24th 2018) comes out in strong support for infrastructure-based competition and recognises that it is not feasible to encourage infrastructure-based competition in the broadband market but not do so in the BC market, as these two downstream markets share the same physical infrastructure to a substantial extent.

4.1.10 Simultaneous (or near simultaneous) introduction of DF and DPA remedies that are both priced using BT's costs[5], (despite Ofcom trying to actively encourage competitive providers to use the DPA remedy to build their own fibre networks to compete with BT so that they can develop a commercial market for wholesale dark and lit fibre services) sends conflicting make/buy signals to operators in the UK. The DF pricing would make it very unattractive for operators to build their own fibre connections to the (current) BT-only exchanges[6].

4.1.11 Should operators, nevertheless, build their own connections to some (current) BT-only exchanges, those exchanges would cease to be BT-only exchanges. Zayo believes Ofcom should make it clear what happens to BT's DF obligation when this happens. Zayo presumes that the DF obligation would fall away, thus reinstating investment incentives for operators to use DPA and build their own fibre connections.

4.1.12 It seems much more consistent with Ofcom's strategy and accepted economic principles that the DPA remedy be implemented first and that DF be implemented only where and if the DPA remedy has failed to overcome the market failure identified.

4.1.13 Zayo is present in a number of BT exchanges and will review the business case for establishing a presence in BT-only exchanges once the unrestricted DPA remedy is implemented as proposed in the concurrent PIMR consultation.

4.1.14 If/when a DF remedy is introduced in the (then) BT-only IEC market the remedy should be priced in a manner to ensure that sufficient economic space exists between the two remedies for efficient providers to use the DPA remedy and compete with the regulated DF remedy, and to ensure that any investment made by providers during the period without the DF remedy are not devalued by an artificially low DF remedy price.

4.1.15 Despite this BCMR covering only a two-year period, Zayo considers it imperative that Ofcom sets out on a path that is consistent with its strategic statement and which will generate longer-term stability and investor confidence. It is inappropriate to impose two parallel

[5] Zayo considers it appropriate to BT's costs for the DPA remedy as DPA is the most up-stream remedy possible and Ofcom correctly wants to discourage any potential inefficient network duplication. By pricing using BT's costs, other providers will only build their own physical infrastructure where the DPA remedy is not effective (either the remedy is not fit for purpose, or BT's infrastructure is unsuitable for building new all-fibre networks) or where the provider can do this more cheaply that using BT's infrastructure.

[6] Section [7.3 of the IIG submission] presents a more detailed analysis of why Ofcom's proposed pricing would be a direct deterrent to operators otherwise wishing to use the DPA remedy to connect to additional BT exchanges.

passive remedies at the same time, and particularly so if the pricing of one remedy directly discourages the use of the other.

4.1.16 The IIG submission further provides comments on the actual definition of the DF remedy including the absence of a distance limitation (which Zayo believes is required) and the unintended consequence of further embedding BT's exchange locations into the design of new fibre networks, rather than encouraging the development of new fibre networks that are designed to optimise efficiency and resiliency, rather than using BT locations as default due to regulatory design. Zayo supports those comments and asks that Ofcom makes the remedy description as clear and unambiguous as possible (if the remedy is introduced).

Proposed pricing for DF services

4.1.17 In addition to our concerns about simultaneous introduction of the DPA and DF remedies, if Ofcom does introduce the DF remedy then Zayo believes that the approach to pricing is flawed; the use of BT's FAC costs to set the initial price for inter-exchange dark fibre, followed by a CPI-CPI control, is not an appropriate approach.

4.1.18 [✂]

Figure 1: [✂]

4.1.19 [✂].

4.1.20 Zayo therefore believes that the DF pricing proposed does not allow sufficient economic space between the DF and PIA prices to allow for investment in fibre cables by new entrants making an economically rational decision.

4.1.21 Zayo believes that, if the DF remedy were to be introduced, a more appropriate pricing approach would be to use reasonably efficient operator (REO) costs, assuming that the REO uses PIA to the extent available. Once PIA becomes more established, Ofcom will be able to access much better data in the feasible extent of PIA usage, and the costs, and this could be used as a base to which the REO costs of installing and operating the cables could be added.

Leased Lines Charge Control

4.1.22 As set out in the IIG submission, Zayo warmly welcomes Ofcom's new approach to the setting of the leased lines charge control (LLCC) changing from the previous focus on seeking short term static benefits from price reductions to seeking longer-term dynamic benefits from infrastructure-based competition.

4.1.23 Despite operating primarily in the dark fibre market (wholesale and retail), Zayo's customers are extremely well-informed of BT's retail and wholesale products and charges. BT's OSA Filter Connect product is being marketed aggressively to challenge us in the provision of dark fibre services. For our active services, customers can compare directly against BT's published 1G and 10G products and prices.

4.1.24 Further, as correctly recognised by Ofcom in this consultation, the advantage afforded to BT by it being already present in most locations (and a very short distance from the remainder) is significant. Time to deliver service is often a critical factor for our customers. This is why

Zayo welcomes Ofcom's proposal to keep the leased prices stable for the duration of this LLCC rather than reducing them further and making it even harder for us to compete against BT. After the very aggressive reductions imposed under the 2016 BCMR, Zayo is very much feeling the pressure from lower BT pricing.

4.1.25 Zayo believes that there are substantial benefits to customers from the availability of competing fibre networks to serve the BC market. Modern high-quality fibre networks, built in ring-configurations deliver more reliable services and are more resilient. For example, the increased resiliency of our networks as compared to BT's legacy network, means that some customers choose to not purchase physically redundant connections to their sites, where they would have had to do so if using BT.

4.1.26 Zayo is aware of a study performed for CityFibre during the summer of 2018, investigating the value placed by telecoms buyers of infrastructure competition in the BC market and Zayo understands that CityFibre will be attaching the report from that study to its response to the BCMR. That report shows clearly that telecoms buyers value the features and benefits offered by operators using their own networks compared to those using the BT network.

4.1.27 As explained in the IIG submission, however, Zayo believes that Ofcom's proposal to impose a CPI-CPI LLCC could backfire. This is due to the very uncertain micro- and macro-economic conditions that prevail at the moment, including the unknown impact of the as yet unknown Brexit outcome. High inflation could cause operator to have to reduce real prices substantially (defeating Ofcom's objective of providing price stability to investors) in the face of increasing costs, whereas deflation could result in real price increases.

4.1.28 Zayo, and the other IIG members, therefore propose that Ofcom adopt a much more predictable LLCC formula of CPI-0%. This would keep prices stable in real terms and reduce the uncertainty at a time where many providers are seeking investment in an already very uncertain economic climate.

The treatment of discounts

4.1.29 Zayo agrees with Ofcom that time-limited discounts should not count towards BT's compliance with the LLCC. Zayo also agrees with the statements in the IIG submission that BT is making significant use of discounts, despite these not counting towards the LLCC compliance and, therefore, Ofcom needs to ensure that BT's ability to discount is kept within reasonable parameters.

4.1.30 Zayo suggests that BT discounts should be specifically justified to Ofcom if they exceed a specific threshold. This could for example be 20%, meaning that if BT wanted to introduce a discount of >20% on any one price, then it would need to submit a cost-based justification for doing so.

4.1.31 Zayo understands that Ofcom would generally not wish to engage in that level of pricing oversight, but Ofcom's table 5.2 of the BCMR volume 2 demonstrates clearly that BT has been offering significant discounts in recent years, despite those discounts not counting towards compliance with the LLCCs that have been in place. Zayo believes that this suggests that BT is using discounts (whether general, volume or geographic) tactically in the market, targeting products and geographies where it is seeing emerging competition.

4.1.32 The impact of the 2016 LLCC has been devastating to competing network operators in the UK. This was clearly demonstrated in Ofcom's analysis of dig distances in 2017, compared with the dig distances recorded for during the analysis to support the 2016 BCMR. Dig distances have more than halved[7], clearly indicating that competitive providers can no longer justify digging more than very short distances to connect customers, due to the pressure from BT's regulated wholesale leased liens prices, which were almost halved over the past three years.

4.1.33 Ofcom's proposal in the PIMR to make completely unrestricted duct and pole access available will go some way towards compensating for the impact of the 2016 LLCC, as it will reduce the costs of network deployment, but it will not be able to half the costs of network deployment. Competitive network operators are therefore under considerable pricing pressure even with the proposed CPI-CPI LLCC; aggressive targeted discounting by BT would without doubt increase that pressure and the revenue impact could outweigh the benefits to operators of using duct and pole access.

Pricing in HNR market

4.1.34 Ofcom proposes to apply no direct price regulation in the HNR market, but that "fair pricing" rules should apply. Zayo notes that neither Volume 1 or Volume 2 of the BCMR consultation (or the annexes to those volumes) provide any further clarification as to what Ofcom means by the application of fair pricing rules.

4.1.35 Zayo has explained above why it believes that the HNR areas are defined using the wrong network reach threshold (65% instead of 90%) and that the proposal to not apply the LLC in a market defined using the 65% threshold would lead to premature deregulation, which could cause serious harm to the emerging competition in the BCM.

4.1.36 Zayo believes that Ofcom has to either: 1) retain its current market definition, but impose the LLCC in the HNR market, or: 2) change the HNR market definition to using the 90% reach threshold and in that case, Zayo believes it would be appropriate to not apply the LLCC remedy.

5 BCMR Preventing anticompetitive pricing by BT

The need to prevent anti-competitive pricing by BT

5.1.1 Ofcom does not propose specific measures to prevent BT from pricing in an anti-competitive manner, thus deterring investment in competitive networks; Zayo is very concerned that BT will take advantage of the flexibility offered by the proposed LLCC to reduce prices of specific products, possibly targeted at certain geographic areas, to stave off new competition.

5.1.2 Competitive providers, including Zayo, are investing substantial funds in building fibre infrastructure networks and this poses a threat to BT's dominant position in the fixed telecoms markets. Apart from Virgin Media, most of the competition to BT takes the form

[7] See paragraph 4.5.7 and following paragraphs in the IIG submission.

of retail businesses selling on BT's wholesale services; as a result, while BT has lost retail market share it has been able to retain a substantial share of the wholesale market.

5.1.3 So Zayo believes that BT will act on the powerful incentives it has to deter investment in competitive infrastructure.

5.1.4 Ofcom refers in the BCMR to the objective of promoting network-based competition[8], that the long-term benefits of network-based competition will be substantial[9], and that the benefits of stability at current price levels will outweigh any static inefficiencies from over-recovery by BT during this charge control period[10].

5.1.5 This implies that Ofcom considers the benefits of relaxing the downwards pressure on BT's prices through a continuation of the type of LLCC currently in force outweigh the short-term static efficiencies available through immediate price reductions. Zayo understands that the main outcome Ofcom is seeking through the proposed approach is investment in competitive all-fibre networks.

5.1.6 Ofcom's Cost Orientation Review in 2013[11] identified that price floors set above the dominant provider's incremental/LRIC costs can be appropriate if the medium to long term benefits to consumers from the resulting investment and competition can be identified as sufficiently large. Ofcom itself has discussed the substantial benefits it expects from the availability of full fibre networks to residential and SME consumers in the UK and such benefits are typically measured in £billions, significantly higher than the likely costs almost regardless of both how Openreach might price its >100Mbit/s services if left unconstrained, and of the number of consumers that would migrate to >100Mbit/s services during the charge control period.

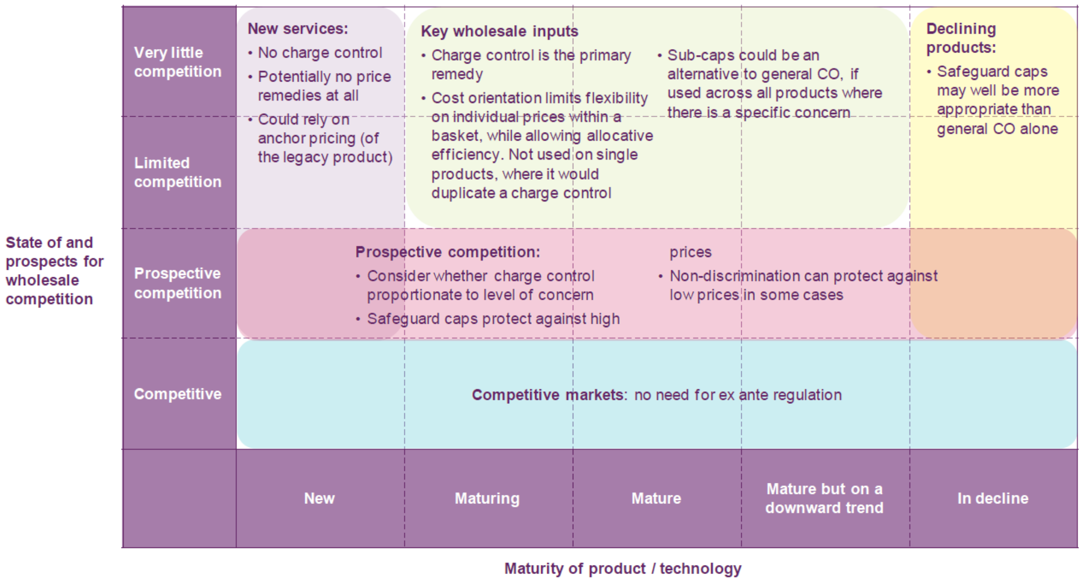
5.1.7 In its 2013 Cost Orientation review paper, Ofcom discusses the use of price floors to encourage investment. In particular, in paragraph 2.47 Ofcom states:

"We also need to take into account the risks of inefficient entry and competition. For example, if we set an artificially high floor which is above actual costs, we may encourage entry into the wholesale market by competitors with higher costs than the incumbent. In a static analysis, this would be inefficient and undesirable. However, in the longer run, such entry might be desirable as, although it could raise costs in the short-run, in the long-run such inefficiencies could be more than offset by the likely dynamic benefits of greater competition." [emphasis added]

[8] See para 10.6 V1.
[9] See para 10.7 V1.
[10] See para 2.13 and 2.14 V2.
[11] https://www.ofcom.org.uk/__data/assets/pdf_file/0018/63261/cost_orientation.pdf

5.1.8 Additionally, in Figure 5 of that same document, Ofcom considers how different remedies are likely to be appropriate under different market conditions:

Figure 5 Possible approach to setting remedies in different market conditions



5.1.9 Zayo considers this framework to be very helpful; it identifies that specific attention should be paid to market conditions characterised by prospective competition and where the technologies used are not yet fully mature. (The above table, however, appears to not have been populated fully in line with the preceding analysis in the paper, as it does not consider the application of price floors despite this being specifically addressed in paragraph 2.47 of that same paper as presented above).

5.1.10 While the benefits of network-based competition can be difficult to quantify, Zayo understands that CityFibre has commissioned research into the behaviour of telecoms buyers during the summer of 2018. The results of this survey suggest that customers perceive significant benefits to the offerings of network-based competitors, but also that in order to persuade customers to switch away from established operators, a substantial price discount is needed.

5.1.11 Given the vulnerability of emerging infrastructure competition to potential anti-competitive pricing by BT, Zayo has significant concerns regarding the lack of pricing constraints applied by Ofcom under the LLCC proposals.

Pricing flexibility under the CPI+5% safeguard control

5.1.12 Zayo notes that individual products within the 1Gbit/s and below basket are subject to a CPI+5% sub-cap, and that Ofcom intends that this should limit BT's ability to game the charge control design, as well as limiting the scope for price increases[12]. Ofcom have not presented any analysis to support the level of this 5% cap, but states that it is based on a regulatory judgement which balances Ofcom's objectives[13].

[12] See paras 3.53 to 3.54 of V2.
[13] See para 3.55 of V2.

5.1.13 Zayo has commissioned some modelling which suggests that, with a 5% sub-cap, BT would have an opportunity to significantly decrease the price of 1Gbit/s ethernet services, while still maintaining the basket revenue at CPI-CPI, by increasing the real prices of lower speed services by 5%.

5.1.14 For example, if 10Mbit/s and 100Mbit/s services were subject to a CPI+5% price increase in each of the two years of the charge control, then the prices of 1Gbit/s services could be reduced by 39% over the two years, while still maximising the return for BT of services within the basket. The following table shows the results from this model, which is run with an inflation assumption of 2.2%. [14]

Table 1: Scenario showing price reduction on all 1G lines with CPI-CPI for basket, CPI+5% for low speed products

	Product	Rental price (£/year, nominal)			Price change
		Current price	FY 2019/20	FY 2020/21	over 2 years
Price increase at CPI+5%	10Mbit/s EAD	1,698	1,820	1,951	15%
	100Mbit/s EAD	1,698	1,820	1,951	15%
Reduction targeted at all 1G lines	1Gbit/s EAD	1,890	1,531	1,147	-39%

5.1.15 If BT were to only reduce the 1Gbit/s service pricing in parts of the country where it faces competition from operators building new competing networks[15], that reduction could be significantly higher. The table below shows the impact if the price reduction were restricted to 70% of BT's 1Gbit/s EAD and EADLA customers, with the remaining 30% following the CPI-CPI basket average. A price decrease of 56% is possible in this scenario, taking the price to below half of the 100Mbit/s price.

Table 2: Scenario showing price reduction on 70% of 1G lines with CPI-CPI for basket, CPI+5% for low speed products

	Product	Rental price (£/year, nominal)			Price change
		Current price	FY 2019/20	FY 2020/21	over 2 years
Price increase at CPI+5%	10Mbit/s EAD	1,698	1,820	1,951	15%
	100Mbit/s EAD	1,698	1,820	1,951	15%
Reduction targeted at 70% of 1G lines	1Gbit/s EAD	1,890	1,378	828	-56%

5.1.16 One way of reducing BT's scope for such significant price reductions for the 1Gbt/s services would be to apply a CPI-0% control instead of the CPI-CPI control. The table below shows the potential 1Gbit/s price reductions under the CPI-0% control, while maintaining basket revenue:

Table 3: Scenarios showing price reduction on 1G lines with CPI-0% for basket, CPI+5% for low speed products

[14] See Annex [x] for a description of the model. The Excel model is supplied separately.

[15] Zayo understands that whilst geographic discounts do not count towards the LLCC, permanent changes to prices in some geographic areas would.

	Product	Rental price (£/year, nominal)			Price change over 2 years
		Current price	FY 2019/20	FY 2020/21	
Price increase at CPI+5%	10Mbit/s EAD	1,698	1,820	1,951	15%
	100Mbit/s EAD	1,698	1,820	1,951	15%
Reduction targeted at all 1G lines	1Gbit/s EAD	1,890	1,690	1,468	-22%
Reduction targeted at 70% of 1G lines	1Gbit/s EAD	1,890	1,587	1,251	-34%

5.1.17 Another way of reducing BT's potential to game the LLCC would be to change the CPI+5% safeguard provision to CPI+2%. The table below show the impact this would have.

Table 4: Scenarios showing price reduction on 1G lines with CPI-CPI for basket, CPI+2% for low speed products

	Product	Rental price (£/year, nominal)			Price change over 2 years
		Current price	FY 2019/20	FY 2020/21	
Price increase at CPI+2%	10Mbit/s EAD	1,698	1,769	1,844	9%
	100Mbit/s EAD	1,698	1,769	1,844	9%
Reduction targeted at all 1G lines	1Gbit/s EAD	1,890	1,681	1,463	-23%
Reduction targeted at 70% of 1G lines	1Gbit/s EAD	1,890	1,591	1,280	-32%

5.1.18 If combined, the CPI-0% and a CPI+2% safeguard cap would have the following effect:

Table 5: Scenarios showing price reduction on 1G lines with CPI-0% for basket, CPI+2% for low speed products

	Product	Rental price (£/year, nominal)			Price change over 2 years
		Current price	FY 2019/20	FY 2020/21	
Price increase at CPI+2%	10Mbit/s EAD	1,698	1,769	1,844	9%
	100Mbit/s EAD	1,698	1,769	1,844	9%
Reduction targeted at all 1G lines	1Gbit/s EAD	1,890	1,840	1,784	-6%
Reduction targeted at 70% of 1G lines	1Gbit/s EAD	1,890	1,800	1,703	-10%

5.1.19 This modelling shows that Ofcom's proposed charge control structure for the ethernet 1G and lower basket, based on CPI-CPI with CPI+5% for individual products, would allow BT considerable freedom to reduce prices of 1Gbit/s products, even on a broad geographical basis covering 70% of lines. While this modelling does not factor in the effects of migration from lower speeds to 1Gbit/s products that would result from such drastic price reductions, and that this would provide some limit to sustainable reductions, it should be noted that BT could choose to narrow the geographical scope of price reductions and target specific areas of competition, thus avoiding revenue losses in less competitive areas.

5.1.20 Zayo is concerned that, while Ofcom has stated that the design of the LLCC is intended to limit BT's ability to game the prices, the proposed LLCC does allow BT very significant freedom to undermine pricing in competitive areas. Zayo therefore suggests that Ofcom considers applying further constraints on BT's pricing freedom by moving to a CPI-0% control on the main basket, and also by considering reducing the CPI+5% control on individual products. However, it is clear that such an approach will not in itself be sufficient to prevent anti-competitive pricing, and other measures should also therefore be considered.

The case for a price floor in the BCM

5.1.21 Zayo believes that while a change to CPI-0% and restriction of the individual product control to CPI+2% would be helpful in limited BT's opportunity to cause harm by targeted price reductions, it would remain possible for BT to achieve large reductions by further restricting the geographic scope of the reductions. If the reductions were targeted at only a few key cities, then the charge control, absent any explicit price floor, would allow BT to reduce prices to close to zero, leaving only ex-post competition law as a constraint.

5.1.22 The standard test for predatory pricing is whether the dominant provider covers its incremental costs. This is, however, not an appropriate measure in network industries like telecoms where there are substantial sunk costs and high economies of scale[16]. The incremental costs of a provider with market dominance (and by definition a market share not achievable by any other operator as only one provider can have >50% market share) will be so low that no other provider would be able to compete, so applying incremental costs as the threshold for predatory pricing in telecoms is therefore inappropriate, as recognised by Ofcom in its 2013 Cost Orientation Review paper.

5.1.23 Considering that duct comprises a high proportion of the assets used to deliver EAD services (the 2017 RFS suggests around 40%), and that this would be treated as largely common cost under a LRIC methodology, it seems clear that the incremental costs would indeed be well below fully allocated costs. Analysis using cost-volume elasticity data from Ofcom models suggests that a LRIC price would be no more than 30-40% of FAC, which would clearly not be a sustainable level for new market entrants.

5.1.24 Zayo believes that the most appropriate measure for setting a price floor would be the costs of a reasonably efficient operator (REO) to provide the relevant service. If upstream remedies (including duct and pole access) are available in the market, then the REO costing model should take that into account to ensure that such efficiencies are included and that no inefficient network replication costs are included.

[16] Ref: Deutsche Telecom Case C-280-/08 P, October 14 2010 and *Konkurrensverket v TeliaSonera Sverige AB, Case C-52/09.*

6 Zayo's response to the RFR consultation

6.1.1 Zayo refers Ofcom to the response to this consultation submitted by the IIG.

6.1.2 Zayo is very concerned that the reduction in reporting levels will reduce our ability to make meaningful analysis of BT's pricing initiatives and of Ofcom's charge control proposals. Zayo believes this would cause Ofcom to make less informed decisions and could impact negatively on the market and ultimately on consumers and citizens.

6.1.3 As a member of the IIG, Zayo contributed to the response to the RFR consultation submitted by the IIG and is in full agreement with the contents.

7 Annex 1 – [✂]