Strengthening Openreach's strategic and operational independence

Telefonica UK Limited response

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Telefonica UK Ltd ("O2") welcomes the opportunity to respond to Ofcom's consultation on strengthening Openreach's strategic and operational independence[1].

O2

O2 is an indirect wholly owned subsidiary of Telefónica S.A., a multinational telecommunications company based in Spain. It primarily operates in the UK under the O2 brand and provides a range of mobile communications services including voice, text and data connections via its 2G, 3G, 4G and Wi-Fi networks. O2 also provides mobile communication services through its online only sub-brand, giffgaff. At the end of June 2016, O2 had 25.2 million customers.

In addition, O2 and Tesco Mobile Services Limited operate a 50:50 joint venture, Tesco Mobile Limited (Tesco Mobile) – an MVNO that offers a range of mobile communication services on O2's network under the Tesco Mobile brand.

O2 has over 450 retail stores and sponsors The O2 Arena in London, O2 Academy venues and the England rugby team.

For the six months ending June 2016, O2 reported revenue of 3,464 million euros, including revenue from mobile services of 2,633 million euros, and OIBDA of 918 million euros[2].

Ofcom's rationale for intervention

In section 3 of the consultation document, Ofcom sets out the justification for seeking to make Openreach's governance more independent from BT. At paragraph 3.1, Ofcom says that at the heart of its concerns is the continuing incentive and ability of BT to discriminate against its downstream customers due to its vertically integrated structure and position of significant market power.

BT's acquisition of EE in 2015 has, in O2's view, added an extra dimension to such concern. Prior to the acquisition, BT played a minor role in the UK mobile sector. However, now it owns the country's largest mobile provider. Accordingly, BT has added a further downstream provider; and one which competes directly with O2. Therefore, in O2's view, in considering Openreach's governance, Ofcom should take into account BT's incentive and ability to discriminate against its mobile competitors. It is not clear to O2 whether and how Ofcom has taken into account this new factor.

As a predominantly mobile provider, O2 has two main concerns: BT's excessive returns and how the detrimental impact of those returns on consumers and competition; and mobile backhaul.

[1] Strengthening Openreach's strategic and operational independence. Proposal for comment. Ofcom 26 July 2016 http://stakeholders.ofcom.org.uk/binaries/consultations/strengthening-openreachs-independence/summary/condoc.pdf

[2] Telefonica Results January – June 2016. https://www.telefonica.com/documents/162467/51547305/rdos16t2-eng.pdf/72a3a702-49f4-40da-a2ae-ff0e86265676

BT's excessive returns

In its discussion document published in July 2015, Ofcom stated that:

> *"BT's returns on its regulated markets have consistently been greater than returns consistent with our estimate of its cost of capital."*[3]

and sought to quantify the excessive returns over the nine years to March 2014:

> *"we estimate that the gap between BT's returns and the benchmark cost of capital is £4bn"*

In O2's view, that is a significant sum. Returns in excess of cost of capital is troubling from a regulatory point of view for two reasons. Firstly, the implication is that prices consumers face for downstream services have been higher than they should have been. Secondly, returns in excess of cost of capital can distort competition, because BT is able to cross subsidise its activities in other markets (such as retail markets). Further, given that the excess returns have been made from BT's wholesale customers, that are also its competitors in downstream markets, the effect on competition is effectively doubled. In other words, it is BT's competitors that must contribute towards a war chest that they must then compete with; an anti-competitive "double whammy".

In the July 2015 discussion document, Ofcom invited comments on whether Openreach's returns required additional policy action to protect end-users and limit the risk of competitive distortions. Various respondents made the case for structural separation partly on the basis of the problem of cost allocation (see, for example Sky's and Vodafone's responses).

In its initial conclusions document of February 2016[4], Ofcom observed that, under the current functional separation regime, there is an inherent risk of competition concerns, including in relation to cost allocation and discrimination:

> *"BT will always have the incentive to choose attribution rules that increase the reported cost of regulated services or favour its downstream divisions compared to other competitors. Despite the steps described above, the complex nature of BT's regulatory accounts, and inherent information asymmetry mean that the risk of inappropriate allocations going undetected cannot be entirely avoided."*[5]

In the same document, Ofcom also appeared to accept that complete structural separation offers the best prospect of eliminating such concerns:

> *"The primary advantage of structural separation is that it removes the ability and incentive of the provider of the 'non-competitive activity' to engage in discriminatory actions that restrict competition in 'competitive activities'. Other models of separation simply limit the ability to discriminate to varying degrees, but do not change the underlying commercial incentives. Structural separation is therefore the cleanest and most clear cut long-term solution."*[6]

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[3] Paragraph 4.70 of Strategic Review of Digital Communications, Discussion document. Ofcom 16 July 2015. http://stakeholders.ofcom.org.uk/binaries/consultations/dcr_discussion/summary/digital-comms-review.pdf
[4] Making communications work for everyone. Initial conclusions from the Strategic Review of Digital Communications. Ofcom 25 February 2016. http://stakeholders.ofcom.org.uk/binaries/telecoms/policy/digital-comms-review/DCR-statement.pdf
[5] Paragraph 6.46 refers
[6] Para 6.57 refers

However, Ofcom rejected the notion on the basis that it was not a cure for all ills and that it would be costly to achieve. Accordingly, Ofcom has developed the current set of proposals.

Section 3 of the current consultation document sets out the basis for Ofcom's proposed intervention. The opening two paragraphs are instructive:

> *"3.1 In this section, we explain why we need to reform the relationship between BT and Openreach. At the heart of our concern is the continuing incentive and ability of BT to discriminate against its downstream customers due to its vertically integrated structure and position of significant market power.*
>
> *3.2 Given this incentive, we are concerned that the degree of BT Group's influence over strategic decisions, including lack of consultation by Openreach with its downstream customers, creates risks to both competition and investment. To address this concern we are proposing to give Openreach greater independence over strategic and operational decisions affecting the network, so that these decisions reflect the interests of all its customers, not just BT Group"*

The emphasis appears to be about strategic decision making and its impact on competition and investment. There seems to be little consideration to the issue of returns in excess of the cost of capital and the consequential impact on consumers (through higher prices) and competition (through cross-subsidy). The point appears to be emphasised in section 6, in which Ofcom discusses how the success of its proposal should ultimately be assessed:

> *"6.5 One of the most important measures of success of our proposal is our ability to assess whether Openreach Board decisions are taken in an independent manner, without undue influence from BT Group. The increased transparency resulting from the new governance processes will be one of the most important aspects of this assessment. We propose also to seek evidence from customers on the responsiveness of Openreach, in particular to new investment ideas and new models of co-investment.*
>
> *6.6 In practice, there are a number of measures of success against which we propose to judge how effective our model is in addressing the concerns we have identified. Some examples include:*
>
> > *6.6.1 The ability for Ofcom to assess whether Openreach Board decisions are taken independently, without undue influence from BT Group*
> >
> > *6.6.2 Evidence from customers on the responsiveness of Openreach, in particular to new investment ideas and new models of co-investment*
> >
> > *6.6.3 Whether Openreach has the necessary commercial and technical resource required to deliver its priorities in the interests of all its customers*
> >
> > *6.6.4 A published Openreach annual report, setting out how Openreach has determined its priorities and what it has done to deliver these*
> >
> > *6.6.5 Compliance with rules related to the proposed model, in particular those rules relating to new governance arrangements for Openreach"*

Again, none of this appears to relate to the excessive return issue.

This is a concern to O2. It now competes directly with a BT downstream business (EE). Ofcom appears to acknowledge that BT has made excessive returns in the past, conceded that such returns can have an adverse impact on consumers and competition and that the only sure way to deal with the problem is through structural separation. Ofcom's proposal falls short of this and it now seems that Ofcom has decided not to focus at all on the excessive returns issue.

O2 would welcome some clarity on the matter. In particular:

1. how is Ofcom to monitor the extent to which Openreach is able to make returns in excess of its cost of capital in the future?

2. how will Ofcom measure the impact of such returns on consumers and competition? and

3. what would Ofcom's response be if it were found that excessive returns have been detrimental to consumers and competition?

Mobile backhaul

Mobile operators are reliant on Openreach to a large degree (either directly or through services provided by BT Wholesale) for mobile backhaul[7]. There has always been concern amongst mobile operators about aspects of BT's transmission services, including in relation to quality, product development and price. Mobile operators have been of the view that BT is an unavoidable trading partner, due to the ubiquity of its network, and that it is BT's market power which is the root cause of the problems associated with its mobile backhaul services.

Responses to Ofcom's business connectivity market reviews over the years bear this out (including from EE prior to its acquisition of BT).

In this regard, O2 also notes the CMA's finding in last year's report into BT's acquisition of EE:

> "*We therefore found that there were distinct product markets for:*
>
> > *(a) the supply of managed fibre Ethernet-based mobile backhaul; and*
> >
> > *(b) the supply of (terminating segment) unmanaged fibre Ethernet-based leased lines (including the supply of dark fibre*)."[8]

The finding of a distinct product market for the supply of fibre Ethernet-based mobile backhaul is, O2 believes, consistent with the position that mobile operators have traditionally taken on the issue. Further, given its massive market share the commonly held view that BT is an unavoidable trading partner, O2 also believes that BT enjoys a position of dominance in that market.

The CMA considered various foreclosure strategies that BT might adopt following the (then) proposed acquisition of EE. They were[9]:

a) foreclosure by increasing the price of Openreach Ethernet leased lines;
b) foreclosure by discriminating on the quality of Openreach Ethernet leased lines;
c) foreclosure through frustration of innovation by Openreach;
d) foreclosure by withdrawing supply of BT Wholesale's managed backhaul services (or offering worse contractual terms) at contract renewal;
e) foreclosure by increasing the price or reducing the quality of BT Wholesale's managed backhaul services under the current contracts; and
f) the pursuit of a margin squeeze strategy by the merged entity as a whole.

O2 acknowledges that the CMA found that BT's acquisition of EE was not expected to result in a significant lessening of competition in any market or markets in the UK as a result of an input foreclosure strategy in the supply of fibre mobile backhaul. Further, the effect of the Ofcom's decision in the Business Connectivity Market Review, to require BT to provide access to dark fibre, might also be beneficial (subject to terms, including pricing).

Nevertheless, BT now finds itself in an identical position with respect to mobile operators (in respect of mobile backhaul), to the one that it has had in relation to its fixed competitors. That is: its customers are dependent on a BT for an essential wholesale input, in order to compete with a

[7] See, for example, paragraph 15.2 of the Competition and Markets Authority report into BT's acquisition of EE, https://assets.publishing.service.gov.uk/media/56992242ed915d4747000026/BT_EE_final_report.pdf
[8] Paragraph 15.3 refers
[9] Paragraph 16.9 refers

BT downstream business. And it is the deficiencies in the current regulatory model (in relation to the provision of fixed services) that has led to the proposal that Ofcom is now consulting on.

Further, as we have noted above, Ofcom's position appears to be that only complete structural separation can address the problem of discrimination in such circumstances:

> *"The primary advantage of structural separation is that it removes the ability and incentive of the provider of the 'non-competitive activity' to engage in discriminatory actions that restrict competition in 'competitive activities'. Other models of separation simply limit the ability to discriminate to varying degrees, but do not change the underlying commercial incentives. Structural separation is therefore the cleanest and most clear cut long-term solution."*[10]

O2 would welcome clarity from Ofcom about how it anticipates that its proposal will address the potential for discrimination in the provision by BT of mobile backhaul.

[10] Para 6.57 refers