

SCOTTISH GOVERNMENT RESPONSE TO OFCOM CONSULTATION

Strengthening Openreach's strategic and operational independence

1. In our response to Ofcom's Strategic Review of Digital Communications (DCR) discussion paper in November 2015, the Scottish Government made clear our view that Ofcom must reform Openreach, in order to drive specific outcomes – higher quality of service standards, transparency of investment and recycling of profits back into infrastructure investment.
2. The proposal that Ofcom has set out in this consultation recognises that the status quo is not acceptable and is not producing acceptable outcomes. In itself, this is to be welcomed. It is equally important that the model of reform that is implemented retains an outcomes focus and delivers (1) greater transparency around BT's commercial infrastructure investment; (2) greater levels of infrastructure investment in those areas where no competition to BT exists at an access infrastructure layer, or is likely to exist; and (3) confidence that BT's position as monopoly infrastructure provider in large parts of rural Scotland will be policed more effectively than it has been in the past.
3. Comment is provided below on the main features of Ofcom's preferred model for reforming Openreach. It is important to recognise, however, that individual elements of the reforms will not, on their own, drive the change that we want to see. They will need to be accompanied by effective use of Ofcom's cyclical market review and other regulatory processes. These could include more detailed monitoring and enforcement of cost allocation rules; charge controls to improve quality of service; more severe penalties for non-compliance; and greater communication of Openreach's investment plans (incorporating views from wider industry).
4. Moreover, there may need to be a shift in Ofcom's role in relation to Openreach. It is widely accepted, and recognised by Ofcom, that the current functional separation model, which resulted from the agreement between BT and Ofcom in 2005, has not worked entirely as envisaged at that time. There are a number of reasons for this but it suggests that Ofcom may need to be more proactive to ensure the successful implementation of the legal separation model proposed. This is vital if Openreach's quality of service is to be improved and there is to be greater transparency around investment levels.
5. The Scottish Government believes that it is vital that a greater proportion of revenues generated by Openreach are re-invested back into its network infrastructure than is currently the case and that Ofcom should play a key role in shaping and monitoring this. That is not a role that Ofcom has traditionally looked to play. However, changes to Ofcom's role in this area are, in our view, vital if we are to deliver on our shared ambitions and bridge the infrastructure gap that has built up over time in parts of Scotland, and in other parts of the UK.
6. Understanding the localised nature of some of the investment challenges should be a pre-requisite for understanding and regulating Openreach's

performance and service quality. In establishing this future strategy, Ofcom should also consider which aspects of Openreach's value chain can and should be regulated through a competitive framework and where a more asset-based regulatory framework may be more appropriate. Different approaches might be applicable in certain areas – for example, in areas where BT is the monopoly provider and where there is little prospect of stimulating infrastructure competition.

7. As outlined in our previous response, our view is that the legal separation model, allied to strengthened and more rigorously enforced regulation, could produce the main outcomes we want to see without the associated disruption to the market. We also endorse Ofcom's view that, if consensus cannot be achieved – or if BT or Openreach do not fully embrace the spirit of the legal separation model - then a model based on full structural separation of Openreach may need to be considered.
8. The consultation paper sets out Ofcom's proposal, alongside BT's own proposal and the 10-point plan for Openreach reform proposed by BT's competitors. The Scottish Government, in conjunction with Scottish Futures Trust, who we are collaborating with on the development of our World Class Digital Infrastructure programme, has identified what we consider to be the fundamental elements of reform. These are summarised below in bold, with reference to Ofcom's own proposals.
 - **Openreach should be separated from the rest of the BT Group as a functioning standalone operating entity.** This is fully addressed by Ofcom's proposal to have Openreach separately incorporated, becoming a company in its own right.
 - **Standalone governance arrangements should be initiated, with a separate board containing external representation (possibly from wider industry) to oversee the operations and performance of Openreach.** We welcome Ofcom's proposal, which will see the new Openreach company have its own Board of Directors and Articles of Association. The level of anticipated external (non-executive) representation on the Board is welcome, although given BT's ability to appoint and remove Directors, we would want to be reassured around Ofcom's oversight of this process.
 - **Standalone governance arrangements should be initiated, with a separate board containing external representation (in the form of a public interest director ('PID') who would have specific duties with respect to wider industry and customers) to oversee the operations and performance of Openreach and adherence to the conditions of its separation / constitution.** We welcome Ofcom's proposal to create a new Openreach company with its own Board of Directors and Articles of Association. The level of anticipated external (non-executive) representation on the Board is welcome, as is the intention that Directors will have a duty to consider the interests of wider customers beyond BT Group. However, given BT's ability to appoint and remove Directors, we would want to be reassured around Ofcom's oversight of this process. In addition, we also believe that the

appointment of a PID by Ofcom, as seen on the Boards of some private sector delivery companies Scotland, could provide greater oversight and accountability.

- **Ofcom should require Openreach to publish a rolling 5-year infrastructure investment plan; Ofcom should then monitor performance against this plan.** Ofcom's proposal obliges Openreach to formally consult all downstream customers on large-scale investments. In our view, this proposal falls short of the more transparent planning that we had envisaged, that would have given Openreach's customers, and wider stakeholders, a more strategic overview of their investment horizon. It would also provide greater transparency in relation to remote and rural parts of the UK, and tie back to Openreach's value chain helping to illustrate where regulatory remedies (either localised or UK-wide) may be required.
- **Openreach's returns to be driven by and, if necessary, regulated on the basis of the long term infrastructure assets of the new standalone business.** Such an approach would also help take into account the significant levels of public subsidy that has underpinned the extension of Openreach's fibre network into rural areas. This is not specifically addressed by Ofcom's proposals and we would welcome further discussions on this.
- **Ability to raise finance separately from BT Group to meet investment requirements and enter into joint ventures.** Ofcom's proposals envisage greater independent financial control for Openreach, but crucially position this as being within an agreed financial envelope set by BT Group. In our view, this could be a missed opportunity; limiting how independent Openreach can be and, in particular, their ability to look for other commercial investment partners beyond BT Group and enter into joint venture arrangements for services and investments. If there was the potential for companies to co-invest in key infrastructure projects with Openreach, those companies would have an interest in the assets on their balance sheet and an influence over quality of service applied to those assets, which should help improve those aspects. Those companies might also be in a position to benefit from regulatory reliefs that might arise through localised regulation.
- **Requirement to reinvest surpluses into infrastructure enhancement, with possible link to regulatory relief in competitive markets, based upon a regulated return.** This is not specifically addressed in Ofcom's proposals. It may be that this is considered part of the market review cycle. However, it is critical that Ofcom approaches this in a joined up, strategic way in order to ensure a strategic outcome.
- **Requirement to invest in fibre products to ensure a future-proofed investment plan is developed.** This is not addressed in Ofcom's proposals. We understand that there may be reluctance on the part of the regulator to require telecoms suppliers to invest in particular technologies. However, there is clear evidence that, in rural areas in particular, BT's copper-based technologies have delivered variable performance for consumers. The need to trigger a step change in investment, and guard against the widening of a

digital divide between urban and rural areas, may require Ofcom to take a markedly different approach than it traditionally has.

- **Introduce an enhanced regulatory and monitoring regime in relation to consumers and service providers; and ensure input/output equivalence access (in relation to services, data provision and investment plans) is available to all operators.** This is not specifically addressed in Ofcom's proposals. In our view, there should be an element of reciprocity applied to other telecoms infrastructure companies in relation to many of the regulatory and monitoring obligations suggested – for example the publication of rolling investment plans and introduction of enhanced performance regulation and monitoring. This would help ensure that the whole industry is operating on a similar basis in those areas where this is appropriate and/or necessary.
 - **Requirement to provide not only PIA to ducts and poles but also to offer dark fibre as a product at both the access and backhaul level to ECC undertakers.** This is not addressed in Ofcom's proposals and may be considered more of an issue for market reviews. Again, it is vital that these issues are considered in a co-ordinated, strategic manner. An obligation on Openreach to provide a dark fibre product may have an impact on the levels of investment made by other operators who are investing in dark fibre and this should be managed. However, it is also possible that such an obligation, when combined with the ability to co-invest, might reduce the overall capital and operational cost of infrastructure provision and increase the overall capital efficiency of investment. This could have a major impact in parts of Scotland, which are often cited as having a marginal economic case.
 - **Requirement to work with all Mobile Network Operators (MNOs) to understand the required infrastructure to support mobile connectivity and how this can be put in place.** Although Ofcom's proposals do envisage greater consultation between Openreach and its customers, including a new 'confidential' phase, where information may not be disclosed to BT Group, this still seems to fall short of a requirement to have a strategic dialogue with the wider industry, in particular mobile network operators, about the type of infrastructure and services that they will need to support the transition from 4G to 5G networks. This adds to the sense, outlined earlier in this response, that if Openreach were to implement Ofcom's proposals in a particular manner, the outcome might not necessarily be as strategic as intended.
9. We do not consider that BT's ten point plan would address the competition concerns identified by Ofcom, or the wider concerns we have highlighted, and, as such, do not believe that it should be adopted.
10. Overall, although Ofcom's proposals hint at the key issues facing Openreach, they do not yet give confidence that they will fully address them. We believe that there needs to be far greater recognition that these proposals must be implemented in conjunction with co-ordinated market review processes to ensure that some of the underlying systemic weaknesses that have contributed to the infrastructure deficit identified in our wider DCR response are fully addressed.

11. We look forward to working with Ofcom and the UK Government to address the two key challenges that require a coherent overall strategic approach for public policy, funding and regulation, namely:
 - The need for fit for purpose telecoms infrastructure and services to support a world-class digital economy; and
 - Ensuring that the regulatory framework does not exacerbate the digital divide and that more remote areas see connectivity improvements in line with other parts of the UK.

12. Reform of Openreach could make an important contribution to resolving some of these challenges; but only if it is refocused around creating a regulatory environment that delivers greater transparency around BT's commercial infrastructure investment and greater levels of that investment, particularly where BT is a monopoly provider.