Increased focus on Openreach behavioural incentives

Openreach is a vertically integrated organisation that offers access and services to its competitors at a number of levels, including active services, passive services and physical infrastructure (PI) access. As an organisation, Openreach has a natural incentive to sell services as far downstream as possible, as that is where it adds most value and generates most revenue. Selling mostly downstream active services also consolidates Openreach's position as the go-to dominant provider of infrastructure-based access services.

Because Openreach is regulated to provide access services to other CPs and those services should be provided on a cost-orientated and non-discriminatory basis, it is important that the costs and revenues and terms and conditions for the consumptions of those services for each product market are identified clearly.

- The separating out of the relevant costs and revenues for each product market enables those who consume the regulated access services to understand how the prices are calculated and to ensure that each service covers all its relevant costs and only the costs relevant to that service market. Absent this level of transparency, the regulated provider would be incentivised to load costs of competitive services (where it faces competition) into the accounts for non-competitive services (where the regulated provider is allowed to recover its reasonably and efficiently incurred costs). If the regulated provider were to do so, it would be cross-subsidising the competitive services from the non-competitive services and could potentially squeeze out its competitors. In the case of Openreach, which provides only few or no competitive services, it could be incentivised to load costs into the passive and PI services in order to make the active products relatively more attractive. By doing so, Openreach could harm the emergency and sustainability of infrastructure competition in the UK.
- The clear and transparent presentation of non-price terms, conditions and processes for the consumption of the regulated services for both internal and external customers helps ensure that the regulated provider does not make it easier to consume the service internally compared to externally and to the undue advantage of the internal customers which may be competing in a downstream market with the external customers, this would, for example, be the case where an Altnet offers wholesale broadband, leased lines or dark fibre services in competition with Openreach.

Ofcom has imposed Equivalence of Inputs (EoI) rules on the furthest downstream active services provided by Openreach, but at the passive level (dark fibre) EoI is not mandated, nor is it mandated at the PI level.

Ofcom has required that BT Group be functionally and legally separated to address the incentives in BT Group to favour its own downstream (and upstream) operations. At the time of mandating the original functional separation of Openreach from the rest of BT Group and the introduction of EoI, Ofcom referenced the 'cumulative materiality' of the many small differences between how the BT network business served its downstream operations and how external customers were served. At the time that Ofcom mandated that separation, the new Openreach business provided only active wholesale services, but, in the nearly 20 years since then, Openreach itself has become a vertically integrated organisation that is now incentivised to impose the same 'cocktail' of small differences in how internal and external customers are served and is therefore at risk of negatively affecting competition through the cumulative materiality of those small differences.

INCA has in the past suggested that the PI section of Openreach be separated from the rest of the business, but, in the absence of such drastic (slow and complex to implement) measures, INCA now asks that Ofcom acknowledge that Openreach is vertically integrated and (inevitably) suffers from the same conflicts as did the BT Group at the time of the functional separation. INCA suggests that Ofcom introduce two sets of remedies to prevent harm to competition and ultimately to consumers.

- Strengthen the current No Undue Discrimination (NUD) provisions at the passive services and PI levels, with a strong impetus to a gradual move towards EoI, and
- Mandate that the Openreach Monitoring Unit (OMU) expand its current remit from monitoring BT Group Commitments (relating to the relationship between Openreach and the rest of BT Group) and WFTMR/TAR remedies compliance, to actively monitor internal provision within Openreach of services between the different layers and design behavioural remedies to govern intra-Openreach transactions and communications.

The TAR process is the ideal opportunity for Ofcom to introduce these changes and it is urgent that they be introduced as soon as possible. The UK telecoms industry is at the cusp of a new era with the prospect of effective network competition in large parts of the country. But the realisation of that market structure will depend critically on new network operators being able to compete with Openreach (and the rest of BT Group) without being disadvantaged in how they can make use of the regulated Openreach services relative to their main competitor, Openreach itself.

INCA has submitted separate papers to Ofcom in relation to improvement in the non-discrimination provisions governing the provision of PIA services and is also preparing a paper commenting on Ofcom's recently released OMU report. Those submissions are closely linked to the concerns expressed in this paper, but INCA's concern in this paper is broader that just the PIA product rules and the operation of the OMU. With this paper, INCA seeks to address the overarching issue of Openreach being a vertically integrated organisation and that Ofcom needs to formally acknowledge that and the risks to competition and consumer welfare resulting from that organisational structure.

Remedies that should be considered include the introduction of accounting separation between the different relevant markets served from within Openreach. At present, for example, there is no accounting separation obligation imposed for the PIA market. Also, the provision of regulated dark fibre is currently treated as inside the wholesale leased lines market, which makes it difficult to understand the costing, pricing and returns for PIA and dark fibre separately, yet, Openreach has strong incentives to structure pricing to encourage its customers to use active circuits instead of the upstream passive products. Without the separated accounts, it is also not possible to see how Openreach imputes the costs of dark fibre and PIA. Imputation of upstream costs into downstream businesses is a principle that has been applied in regulation since at least the 1990s and predates the application of EoI. It is therefore not tied to or dependent on the application of an EoI obligation. The absence of that approach being applied between the different layers in the Openreach product value chain could allow Openreach to favour its own internal downstream customers over external customers.

INCA is aware that there is Ofcom oversight of the development of regulated prices, but the critical importance of the regulated services for Openreach's competitors, and the overriding principle of transparency in regulation and regulatory decision-making, mean that it is necessary and appropriate for operators and their investors to gain confidence that they are operating in parity with, and not disadvantaged relative to, Openreach.

Another activity that could be affected by Openreach's incentives to favour its own downstream operations is the planned exchange closures. Openreach is presently engaging with its downstream customers about how to orderly effect the exit from exchanges due for closure, but there is no transparency of how Openreach itself allows its internal customers to make the necessary changes and access information about timings, processes etc. For example, as space at enduring exchanges is likely to be sought after, what are the processes to ensure that Openreach itself does not have the opportunity to occupy their required space in advance of space being made available to other Openreach customers?

This paper is intended to highlight some issues that arise from the lack of oversight of the vertically integrated operation that is Openreach. The paper is not exhaustive, and INCA considers that Ofcom needs to carefully analyse the Openreach operations across the hierarchy of active and passive products offered to internal and external customers.

INCA asks that Ofcom incorporate this analysis into the TAR process and that it tasks the OMU with the monitoring and publication of key parameters to create transparency to Openreach's external customers that they are treated fairly compared to internal supply within Openreach. INCA will be pleased to provide additional examples and issues to Ofcom in response to a transparent consultation process on this subject matter.