TalkTalk

For Everyone

Wholesale Local Access Market Review

Consultation on pricing proposals for Duct and Pole Access remedies

TalkTalk comments on Openreach response

December 2017

NON-CONFIDENTIAL VERSION

Summary

1 This submission provides some comments on Openreach's response to Ofcom's consultation on pricing proposals for duct and pole access remedies (dated 20 September 2017 and published by Ofcom in November).

Overall approach to setting PIA rental charges

2 Openreach claims that Ofcom should not impose a different pricing approach to Openreach's current approach since "*no major errors in approach were identified*" (§7).

3 Openreach's assertion ignores the proper regulatory process. Under the *ex ante* regulation regime, it is Ofcom's role as regulator to propose regulation (such as prices) in line with its regulatory principles and policy objectives. It is then for Openreach, along with other stakeholders, to comment on these proposals and for Ofcom to revise the proposals if justified (and stakeholders can challenge Ofcom's decisions through appeals). Openreach's suggested approach where Ofcom cannot change Openreach's approach unless it demonstrates errors in Openreach's approach reverses the proper regulatory construct. It is a crude attempt by Openreach to place itself in the place of the regulator.

4 Openreach is unable to prove that its current PIA prices are not excessive. Regarding the justification for its charges Openreach states that: "*our pricing … is a fair representation of the costs of providing the service*" (§7) and "[t]*he strength of the existing methodology is that it was intended to set a broadly fair and stable allocation of costs to users of PIA*" (§66). Hardly glowing praise. Even Openreach can see little objective merit in its own current approach.

5 Openreach does not set out any meaningful arguments against a price cap and also fails to address the policy objectives Ofcom has set for the PIA remedy. Ofcom proposes that PIA prices should "*support competitive investment*", "*ensure a level playing field*" and "*provide potential investors with sufficient certainty*" to develop business plans for infrastructure roll-out incorporating the use of PIA.[1] Openreach provides no evidence that retaining the current approach would support these objectives.

Approach to network adjustment costs

6 Openreach argue against Ofcom's proposal for Openreach to 'fund'[2] network adjustment costs (up to a limit) – in this approach Openreach do not charge PIA

---

[1] Ofcom consultation on pricing proposals for Duct and Pole Access remedies, 1 August 2017, §§1.4-1.9

[2] We describe this approach as Openreach 'funding' the cost though in reality this investment is not in any sense an 'at risk' investment by Openreach since there is effectively a guarantee of full cost recovery

customers for network adjustment costs but rather they recover the incurred costs from all duct/pole users. Openreach's central argument seems to be that the approach breaches Ofcom's cost causality and distribution of benefits principles. They also claim that Ofcom's approach means:

- "*an individual PIA customer is able to drive and spend Openreach capex virtually without limit, and any number of PIA customers can do the same*" (§89)
- exposes them to "*very large financial and operational exposure*" (§85)
- mean there is "*no incentive for the PIA customer to minimise costs*" (§41) "*… or maintain costs controls*" (§86)
- will "*reduce Openreach capital availability to invest in* [FTTP]" (§2)

7 We address these claims below.

8 Openreach argue that the network adjustment costs should be recovered from the PIA customers requesting them. This argument ignores that Openreach itself does not follow this principle – Openreach recovers network adjustment costs (incurred to roll-out its FTTC and FTTH networks) from all duct/pole users not from the FTTC/FTTH customers that 'caused' the network adjustment. Openreach offer no explanation as to why there should be one rule for themselves and another rule for everyone else. Nor do Openreach assess the significant harm to competition that would result from such a discriminatory approach.

9 Openreach's claims regarding risk and cost exposure are significantly overblown:

- What is happening under Ofcom's approach is that an upfront revenue is switched for a guaranteed on-going rental revenue stream (which includes an uplift for return on capital based on a generous WACC). There is no question of Openreach being out of pocket – rather it is simply a change in the timing of cash flows
- As a capital intensive business this type of cash flow profile is 'bread and butter' to Openreach both for large network investments as well as investments made in connecting customers. Most of Openreach's investments (in its networks) are recovered through on-going rental revenue. Furthermore, there are many situations where individual customer demands result in a similar cash flow profile. For instance,
  - when a new MPF line is provided some of the costs are recovered through rental charges
  - on a new Ethernet circuit the equipment cost is not recovered upfront but rather in rental charges
- Whilst reducing unnecessary risk is a sensible objective for Ofcom, there is no requirement for Ofcom to eliminate risk for Openreach (which seems to be what Openreach is suggesting)

- The level of ‘funding’ is small compared to Openreach’s overall CAPEX budget of over £1 billion and so it is not realistic to suggest that Openreach will face “*very large financial and operational exposure”*
- The cost of network adjustment will have no material impact on capital available for FTTH not only because the amount is small but also given capital markets are liquid and efficient BT/Openreach’s ability to raise capital for FTTH should be independent of the cash generated/used by other activities

10 It is simply untrue and/or misleading that cost minimisation incentives will be poor under Ofcom’s approach:

- Openreach will be able to decide how it adjusts its network to free up capacity e.g. whether to clear existing blockage or build new duct. Thus Openreach has the ability (as well as incentive) to minimise costs itself by selecting the lowest cost approach
- By virtue of requesting a network adjustment, PIA customers will be committed to pay PIA rental charges. Thus PIA customers will not request unnecessary network adjustments
- PIA users will in some cases (when the cost is above the limit) have to bear the cost of the network adjustment themselves

11 Openreach’s secondary position is that if Openreach is required to fund network adjustments then “*Openreach needs the ability to exert strong financial and contractual controls, both overall for the PIA service and on an individual adjustment order basis*” (§22). Openreach then goes on to outline in §88 a lengthy bureaucratic process they say is needed to control the exposure. They also argue that they should only fund network adjustment that meet certain tests:

- “*There is a clear and demonstrable material benefit to the Openreach network and its customers;*
- *The works pass a financial assessment of the cost/benefit analysis*
- *The works are directly linked to accurate forecasting required a minimum of 12 months in advance*” (Table 1)

12 These are arbitrary, unnecessary and unjustified requirements.

- There is absolutely no need for these tests since the concern regarding exposure and risk that led to these proposals is significantly exaggerated.
- The relevant test for whether Openreach should fund network adjustments should be founded on the principle of equivalence and cost recovery. When Openreach conduct network adjustments for general maintenance or to allow deployment of FTTC or FTTH they recover costs from all duct users. PIA users should face the same treatment. Thus Openreach should fund network adjustments for PIA customers if Openreach itself would in time be likely to adjust the network in the manner requested either as part of its general maintenance programme or to allow deployment of FTTC or FTTH.

- The additional tests Openreach propose would also hamper the success of the PIA remedy by adding in delay, additional cost and uncertainty. For example:
  - It would be difficult for PIA users to be able to provide specific evidence of whether a particular adjustment would benefit Openreach and/or its customers
  - Such tests are inherently vague (it is notable that Openreach does not describe how these might work in practice). Therefore, it would be very difficult for a PIA user to be able to predict whether the network adjustment would meet the tests. Such unpredictability would increase risk and deter investment
  - Pulling together this evidence would add deadweight cost and delay to an already complex process
- Regarding forecast requirement we support and are willing to provide forecasts. However it is not reasonable (as Openreach seem to suggest) that if a 12 month in advance forecast is wrong then Openreach would not have to provide the network adjustment and/or would not have to fund it. Where Openreach have insisted on forecast requirements for other products they have never demonstrated how or whether poor forecasting has led to an inability to deliver services. Furthermore, the 12 month window for a binding forecast is excessively long since Openreach is able to flex resources within much shorter periods than 12 months.

13 By proposing a bureaucratic and as shown above, unnecessarily complex, process for the implementation of network adjustments, Openreach appears to be both: attempting to delay the implementation of changes to the treatment of network adjustment charges beyond the conclusion of the Reference Offer process; and also, hampering the efficient use of its ducts/poles. We urge Ofcom to require Openreach to implement as many of the improvements to the PIA product as practicable from 1 April 2018, and conclude Reference Offer negotiations on a limited number of outstanding matters within a tightly specified timeframe.

14 Regarding the limit on network adjustments we know of no limit to the amount of network adjustment Openreach would do itself (and recover from all duct users). Therefore the starting point should be that there is no upper limit to network adjustments provided for PIA customers. As we argued in our consultation response, given the degree of uncertainty and complexity of setting an appropriate network adjustment threshold, we consider it would be more proportionate to establish the principle that CPs only require network adjustment under the regulation when it represents the most efficient roll-out approach. Ofcom could then monitor PIA use and associated network adjustment costs as use of the product develops.

15 We note that Openreach puts forward four options for implementing the network adjustment threshold, if it were to be imposed (§154). We consider that its proposal to assess costs over a time period (§154 bullet 4) may have some merit if well designed, but do not agree with Openreach that this would mean the limit should be set at the lower end of Ofcom’s range.

16 Obviously, it is also reasonable for Openreach to expect to recover efficiently incurred costs. Ofcom's proposal ensures just this.

Approach to productisation costs

17 Openreach argue against Ofcom's proposal to recover productisation costs from all duct/pole users. Their argument seems to be based around Ofcom's six cost recovery principles (§41) and in particular that Ofcom's approach breaches Ofcom's own cost causality and distribution of benefits principles. We comment below on Openreach's arguments.

- Strictly speaking, future PIA customers do not cause PIA productisation costs since much of the cost was incurred historically
- If PIA productisation costs are only recovered from PIA customers this could result in very high PIA charges, very low PIA uptake and therefore less FTTP investment and competition. Such an outcome would clearly be harmful to all parties – for example: fewer FTTP networks will not be built meaning all consumers would suffer (whether they use a network based on PIA or not); and, PIA productisation costs would not be recovered by Openreach
- If PIA productisation costs are recovered from PIA customers then the level of recovery will be volatile (given PIA volumes are unpredictable). If PIA productisation costs are recovered from all duct users there will be little volatility since volumes (of say MPF, WLR) are stable and predictable

18 We find it odd that Openreach is arguing against Ofcom's approach for PIA productisation costs given certainty of cost recovery for Openreach is increased by Ofcom's approach. This suggests that Openreach is keen to hinder the success of PIA – contrary to their public stance.

Product improvements

19 We note that Openreach stated that it will introduce "*a semi-automated ordering system very shortly*" (§31). At present no such system has been implemented: a timeline of two years on the systems roadmap was shared at the Passives IWG on 18 October 2017. We are continuing to engage through the IWG on this matter but consider that it will be important for Ofcom to set out clear and specific expectations for automation of the ordering process in its statement in order to hold Openreach to account.

Minimum term

20 Openreach appear to argue that the minimum term should be increased above five years (§83). They seem to justify this as follows:

Openreach needs the ability to exert strong financial and contractual controls and ensure that PIA infrastructure is occupied and paid for on a long-term basis via long term contracts - including mechanisms such as early termination charges to enforce such arrangements. Such charges would be needed to cover the exposure of Openreach and its non-PIA customers who are paying for new network adjustments and would need to be supported by some form of bond or guarantee (§81)

21 We disagree with Openreach's reasoning.

- Openreach's argument seems to be based on the assumption that there is a dedicated "*PIA infrastructure*" – this is not the case since PIA customers use and share existing infrastructure
- Openreach's claim for longer minimum period for PIA rentals appears to reflect that Openreach 'fund' network adjustment costs. However, there will be many ducts/poles that are rented without network adjustments being made – thus any argument about exposure necessitating a long (or even any) minimum term is irrelevant
- Even in cases where Openreach fund a network adjustment, Openreach will not have any exposure since if a PIA customer which requested a network adjustment and then ceases to rent ducts/poles the network adjustment cost will still be recovered in full (from all duct users)

22 The key role of minimum terms in this case is to create the right incentives for PIA users to request network adjustments funded by Openreach. If there was no minimum period a PIA customer could request network adjustments that they do not need. By having a minimum term PIA customers effectively face a cost for requesting network adjustments which ensures they will not request unnecessary adjustments. However, there is not a case for extending it beyond five years.

Accounting approach

23 Ofcom has proposed that the cost of network adjustments that are paid for by PIA customers (e.g. those above the limit) should not be capitalised but instead be accrued in the year the work was done. Openreach has argued that it should capitalise these costs which would (it claims) be consistent with relevant accounting standards and be consistent with the approach that BT takes in its statutory accounts.

24 We consider that there are problems with Openreach's suggested approach:

- Openreach's approach would be inconsistent with the matching principle: "*The matching principle is one of the basic underlying guidelines in accounting. The matching principle directs a company to report an expense on its income statement in the same period as the related revenues*"[3]. This principle would require the expenditure to be expensed in the same year that the charge is levied on the PIA customer (as Ofcom propose). If, as Openreach propose,

[3] https://www.accountingcoach.com/blog/what-is-the-matching-principle

revenue is accrued upfront and the matching cost capitalised and depreciated it would lead to an overstatement of profits in early years

- We are also very concerned that capitalisation will lead to double recovery. There have been three cases where BT has charged and recovered up front for certain costs and then capitalised and recovered in rental charges these same costs again (ECC[4], co-mingling[5], tie-cables[6]). Other case may exist but have not been discovered. This approach is patently wrong. If these network adjustment costs are capitalised then Ofcom must ensure that the resulting assets/depreciation are separately identified so that they are not included in costs stacks used to set future regulated charges

25 Furthermore, we note that there is no need for the statutory accounting to be consistent with the regulatory accounts. There are already several differences between the two which are highlighted by reconciliations in the RFS.

26 Openreach raised the issue of how internal BT use of PIA should be reflected in the RFS (§190). We would expect that internal use of PIA would be properly accounted for in the RFS in the same way that that the RFS show separately internal and external use of other SMP products such as MPF, WLR and Ethernet. We see no reason for any difference in approach. We think this approach should apply whether or not EOI applies to the particular PIA product.

---

[4] Business Connectivity Market Review Statement 28 March 2013 §19.131

[5] WLA Market Review: Further consultation on proposed charge control for wholesale standard and superfast broadband Sept 2017 §4.53

[6] WLA Market Review: Further consultation on proposed charge control for wholesale standard and superfast broadband Sept 2017 §4.33