Non-**Confidential**

Wholesale Local Access Market Review

Recovering the cost of investment in network expansion

Vodafone Response

September 2017

Executive Summary

Vodafone is surprised that Ofcom is proposing that products in the Wholesale Local Access Market should be increased in price in order to allocate additional funds to BT to deliver 10Mb/s broadband service to 99% of households in the UK.

The broadband service delivered by BT in the likely delivery areas have been subject to a market review and charge control since 2011. The products and services BT deliver in this area has been scrutinised and reviewed by Ofcom three times over the last five years in 2010/11, 2014, and is current under review in 2017.

Ofcom took a policy decision back in 2011 and again in 2014 to allow BT to recover additional capital investment by inflating the charge controlled WBA prices in these areas. BT has not invested and thus made excessive returns in this market.

BT has enjoyed excessive returns in these geographic areas; in 2017 alone these were reported in BT's RFS to be in excess of £150million above the profit expected by Ofcom. These 'excessive returns' have not materialised through good fortune; in this case it is due to under-investment in network in these locations. Instead of asking for more money from consumers, BT now needs to use the previously allocated funds and/or these excessive returns to invest in universal broadband.

Vodafone would urge Ofcom to investigate the level of 'excessive returns' (returns above the regulated WACC) resulting from under spent capital since the charge control commenced in this market in 2011. Only if they are below the additional capital BT is now requesting should they consider BT's claim for new additional funding.

1. Introduction

Ofcom has published[1] a supplementary Wholesale Local Access Market Review Consultation in order to potentially ready itself for instructions from the Government, should BT's offer of providing 10Mb/s across 99% of the UK in lieu of a formal obligation, be accepted. This consultation proposes to include incremental costs in the prices of products in the Wholesale Access Market such that all broadband consumers using the Openreach network will pay for this investment.

In this document we set out Vodafone's views on Ofcom's proposals:

In section 2 we set out our thoughts on the need for additional cost recovery

In section 3 we respond to Ofcom's consultation questions

Annex 1 is Frontier Economics report: "Profitability and the Incentive to Invest"

Annex 2 is a profitability assessment by Cartesian of BT's Payphone Business Model

2. Funding Broadband in the UK

2.1 Wholesale Prices in remote rural areas are already subject to a charge control

Ofcom already charge controls wholesale broadband prices in the remote rural areas where BT is now seeking additional funding to deliver 10Mb/s broadband. In July 2011 Ofcom implemented the first charge control that set the price BT had to charge their retail division and other operators for wholesale broadband services in these areas[2]. BT's wholesale broadband access product IPstream has been subject to this charge control since then, i.e. a period in excess of five years.

BT is now offering to invest in remote rural markets which are likely to be the very same geographies, households and businesses that are currently covered by this WBA Market A charge control; but only if they are allowed to recover a further £450-£600 million from the national WLA market in the form of increased GEA and MPF prices.

However the allowable regulatory return in this market (referred to by Ofcom as Market 1 pre 2014 and market A post 2014) and in these geographies has been designed for the last five years to allow BT to invest and receive an appropriate return for that investment: BT have chosen not to do this and thus made supernormal profits.

Frontier Economics' analysis of BT's 2016/2017 Regulatory Financial Statements ("RFS") is attached in Annex 1. It has found that in the last year alone, the Wholesale Broadband Access Market in market A areas has delivered excess returns (returns above the allowable regulatory return/WACC) to BT of over £150 million.[3] This is in part due to Ofcom setting prices on the basis that BT could recover the WACC and depreciation

[1] https://www.ofcom.org.uk/__data/assets/pdf_file/0022/105682/Recovering-the-costs-of-investment-in-network-expansion.pdf

[2] https://www.ofcom.org.uk/__data/assets/pdf_file/0024/36942/statement.pdf

[3] BT's RFS section 5.1; WBA market A, mean capital employed = £373million, return = £206million, regulatory return = [mean capital employed x WACC] http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2017/RRD2017Final.pdf

charge for an additional £332million of investment in the market. There is even an argument to suggest that due to the length of the debate on Broadband USO funding (two years or so) that the prospect of some kind of state aid or a charge control surcharge may have had the effect of discouraging BT from investing itself, with it being more financially astute to wait instead for new sources of funding to be made available.

2.2 Ofcom's current accounting treatment: Ofcom's Hypothetical Ongoing Network Adjustment

When Ofcom constructed the cost stack for WBA services in remote rural areas (currently referred to as Market A) they found that the underlying assets (SDH, ATM network, and the exchange DSLAM equipment) were heavily depreciated, meaning that the mean capital employed by BT in the market was very low. This would have led to lower wholesale prices; however Ofcom 'uplifted' the cost of this asset base to enable/or because BT were investing in 21CN equipment and Ofcom did not want to discourage investment.

> *"The last adjustment was necessary because a number of the assets used in the WBA market are fully depreciated. This is not consistent with our "hypothetical ongoing network" (HON) assumption, where in the absence of investments in 21CN, BT would have had to replace these depreciated assets. As a result, some of the asset values in BT's data were below the level consistent with what we believed a "steady state" value would be. Specifically, we believe that, on average, assets in a steady state would be half way through their economic lives. As such, BT's financial data were unsuitable as a basis for projecting the costs of a hypothetical ongoing network."*[4]
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> *"BT's costs for maintaining the broadband network may be increasing due to the age of the equipment and this could be reflected in its view on efficiency. However, the HON adjustment allows for aging assets to be replaced and so higher costs related to maintaining an aging network would not arise. We believe this provides some support for a higher efficiency assumption to reflect the lower operational costs arising under our HON approach as compared to BT's actual network costs, though we also note that we have increased asset lives in our model, and this could reduce the effect of this.*[5]

Ofcom's policy decision to inflate the WBA cost stack and allow BT to recover additional depreciation charges and cost of capital on assets that did not exist to ensure that when BT did invest they would receive a return in-line with the revised level of capital was taken to ensure BT continued in invest in this market. However BT did not.

It is for Ofcom to make policy decisions that they feel best serves consumers in the market under consideration; however, it is ***inconsistent*** to allow BT to inflate their wholesale prices in these areas to ensure they continue to invest and then also allow **additional capital to address the very same problem** in the proposed WLA charge controls that cover the national market. Ofcom's policy decisions will mean in practice that BT is able to double cover their investment costs in these remote rural parts of the network.

2.3 Ofcom's uplift to BT's cost stacks appears generous

In the WBA charge control, asset depreciation and mean capital employed were both increased to allow BT to invest in 21CN equipment. Although all the detail has not been published by Ofcom for confidentiality

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[4] Paragraph 5.66 https://www.ofcom.org.uk/__data/assets/pdf_file/0024/36942/statement.pdf
[5] Paragraph A7.190 https://www.ofcom.org.uk/__data/assets/pdf_file/0027/63675/statement_annexes.pdf

reasons, we can see the scale of the uplift in the regulated accounts.[6] Appendix 3.3 of the RFS requires BT to report the level of returns in the WBA charge controlled market making adjustments to its asset base so that the capital employed is in line with the investment Ofcom forecast at the time of the charge control. In 2017 the reported capital employed that requires adding (i.e. is still to be spent) to bring the level of actual capital that BT employs in this market up to the allowable and expected amount in the charge control is £311 million. Therefore we can conclude that BT have not invested as forecast and allocated to do by Ofcom's regulation and as a result has enjoyed supernormal profits from these customers. The actual return on capital employed in the WBA charge controlled remote rural areas is reported as being over 60%. If we compare the capital employed in this market in 2016 with the actual in 2017 it can be seen that the capital employed only increased by £5 million. Therefore we conclude that BT have in the last year, and in the prior 5 years made very little investment in this market and therefore enjoyed supernormal profits for a number of years.

2.4 Ofcom's approach over-compensates BT

As we have already described in Section 2.3 above, BT has already been allocated costs in order to invest in WBA Market A (the 10% of the country with little if any broadband competition). However BT has largely not invested in line with Ofcom expectations, and as result, has earned significantly higher profits than Ofcom predicted. BT is now requesting that a further allocation of capital be included in WLA cost stacks in order to make that investment.

Not only will this approach mean that BT is allocated the same costs twice, but this second allocation of capital (that Ofcom currently consults on) is based on a forward looking assessment of likely costs – not actual costs incurred. In our experience forward looking forecasts are often wildly inaccurate in BT's favour.

- We recently asked Cartesian[7] to review BT's existing payphone business to understand its profitability. This business is partly a commercial enterprise and partly subject to a Universal Service Obligation: very similar parameters to the broadband matter under consultation. BT levies a Payphone Access Charge which they have committed to set, based on costs. However, Cartesian has found that the overall business is significantly profitable and there are no net costs that would warrant a Payphone Access Charge to be levied.
- We have previously shared with Ofcom our transparency analysis of the BDUK project[8], where BT was awarded over 90% of the public funding available to roll out broadband in commercially unviable areas. A very broad estimate of the scale of the difference between projections and actuals can be achieved by reviewing the amount of clawback and efficiency savings that the BDUK programme has identified: £0.645m from a £1.7bn programme.

If BT was being allocated funds through a formal mechanism such as a Universal Service Fund, or State Aid or similar, it would be able to apply for funding to cover net costs only: excluding incremental revenue or intangible benefits such as brand enhancement.

[6] 'Appendix 3.3 Adjusted Performance Summary 2016;
[7] See report at Annex 2
[8] https://www.ofcom.org.uk/__data/assets/pdf_file/0021/105249/Vodafone-annex-2.pdf

Additionally if an actual-cost based funding mechanism is not used, then a claw back mechanism needs to be introduced. It is totally unreasonable for consumers to foot the bill for BT's inaccurate predictions and Ofcom to not be able to take account of over-recovery in forward looking price controls.

3. Ofcom's consultation Questions

Question 3.1: Do you agree with our approach to assessing the number of qualifying premises to include in our analysis? Please provide reasons and evidence in support of your views.

Ofcom have forecast that Phase 2 of the BDUK programme will roll out superfast broadband to 95% of the country, and that efficiency savings and take-up clawback will roll out to a further 2%.[9]

> *"there are expectations that further deployment will take place through the completion of the Phase 2 projects, re-investment of efficiency savings and take-up clawback22, other additional public funding, and further commercial rollout. We do not have a committed figure for this rollout but for the purpose of our analysis we have assumed that an additional 2% of premises could be covered by 24 Mbit/s superfast broadband by the end of 2020."*

However considering the government's latest information release[10] where they identify the size of the clawback as being £645million Vodafone considers that the assumption that this will provide only a further 2% of coverage is flawed. To roll-out network to the last more challenging 3% of the country BT has estimated a cost of £450-£600million and we would expect this less challenging area to be cheaper on a per unit basis (even considering that BDUK funds are rolling out a superfast service) therefore we would ask Ofcom to reconsider their input assumptions in light of this latest information.

Additionally, in the future it would be prudent to take into account the accuracy of future BT cost forecasts and business plans and the degree of over-estimating that is inherently included. Very broadly if we consider that total BDUK funds were provided to BT (£1.7bn) then a clawback of £0.645bn represents a 40% over-estimation in the funds that BT actually required. Whilst a bias towards erring on the side of caution may be necessary, some sensitivity to the key assumptions must be recognised.

Question 5.1: Do you agree with our proposed approach to modelling the costs of BT's proposed network expansion? Please provide reasoning for your answer.

Modelling BT's estimate of future costs inherently includes the risk of over-recovery. Ofcom should hold BT to account for their actual future spend in this area. In terms of the WACC to apply to the gifted investment costs Vodafone consider that no risk premium or inflated WACC should be attached to this low risk, funded network roll-out

[9] The consultation, paragraph 3.13
[10] https://www.theregister.co.uk/2017/09/11/gov_claws_back_645m_in_bt_broadband_subsidy/

Annex 1: Frontier Economics report

"Frontier 2017 Profitability and investment incentives"

Annex 2: Cartesian Profitability Assessment of BT Payphone Business Model

"BT_Payphone_Business_Model_Report"