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Promoting competition and investment in fibre networks: Wholesale Fixed Telecoms Market Review 2021-26

Pricing wholesale local access services in Geographic Area 3 with a BT Commitment to deploy a fibre network

Non-confidential version – redacted for publication [✂]

Pricing wholesale local access services in Geographic Area 3 with a BT Commitment to deploy a fibre network – Welsh overview

CONSULTATION:

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Annex

1. Overview

In January 2020, we proposed our approach to pricing wholesale local access (WLA) services in the UK excluding Hull. For areas considered to be less competitive – Geographic Area 3 – we proposed having cost-based prices using a regulatory asset base (RAB) approach which would allow BT to recover any fibre network investments that it makes.

Under the proposed RAB approach, the investment costs of deploying a fibre network would be added to BT's asset base and recovered over all customers, fibre-based and copper-based, in Area 3.

Since publishing our proposals in January, Openreach has committed to extend its fibre network to 3.2 million properties in Area 3. This document sets out our proposed approach to regulation in Area 3, in light of this commitment.

What we are proposing

In January, we set out details of a post-build RAB approach, under which prices are set to recover the cost of the copper network but are allowed to increase as BT deploys a fibre network. However, we expressed a preference for a forecast RAB approach, if Openreach were prepared to commit to building fibre commercially in Area 3 on sufficient scale.

Under the forecast approach, we set a price cap for the duration of the control, which includes a contribution to the recovery of fibre investment costs based on a committed level of fibre deployment. We noted that Openreach had suggested extending the proposed approach to charge controlling WLA services in Geographic Area 2 to Area 3, by indexing copper-based services of bandwidths up to 40 Mbit/s download, 10 Mbit/s upload (40/10) to inflation. We recognised that there could be added advantages of a consistent pricing approach across Area 2 and Area 3. However, we explained that to take this forward we would require a commitment from BT to build a fibre network in Area 3.

In June 2020, Openreach committed to build fibre commercially (i.e. without public subsidy) to at least 3.2 million premises in Area 3 cumulatively by the end of 2025/26.

In light of this commitment, we are consulting on adopting a forecast RAB approach in Area 3 by indexing copper-based services of bandwidths up to 40/10 and allowing pricing flexibility for higher speed services.

Next steps

The closing date of this consultation is 16 September 2020. We expect to publish our final decision relating to the Wholesale Fixed Telecoms Market Review by 31 March 2021.

2. Introduction

Our proposed approach to pricing WLA services

2.1 In January 2020, we set out our proposals for defining markets, assessing SMP and setting remedies in the Wholesale Fixed Telecoms Markets from 1 April 2021.[1] This included our proposed approach to regulating wholesale local access (WLA) services.

2.2 We proposed different approaches to regulating (including pricing) WLA services depending on our assessment of the potential for rival investment in fibre networks in different geographic areas and to what extent that was likely to lead to competition on a scale that would constrain BT's behaviour.

Geographic Area 2

2.3 In Geographic Area 2, which we considered to have the potential for rival fibre networks, we sought to support investment in competing networks. We proposed a package of remedies reflecting this. On pricing, our view was that setting price caps somewhat above Openreach's costs would better support investment in competing networks since this means that building (or sponsoring) an alternative network becomes more attractive relative to buying wholesale services from Openreach. We also considered that higher wholesale prices for Openreach services allow for higher margins on services supplied by alternative networks and that the arrangements would support Openreach's own build of fibre in Area 2.

2.4 We also considered that price continuity was important for supporting investment. Therefore, we proposed to charge control WLA services by inflation indexing copper-based services of bandwidths up to 40/10 only.

Geographic Area 3

2.5 In Geographic Area 3, while we recognised there was potential for rival network investment this was not likely to be sufficiently material that we could rely on the competitive dynamic as in Area 2 to incentivise investment by BT in fibre networks. Our objectives were to promote competition through access to Openreach's wholesale services while also supporting BT's deployment of a fibre network.

2.6 We considered a Regulatory Asset Base (RAB) approach would help us ensure consumers are protected from excessively high prices whilst providing Openreach with incentives to invest.

[1] Promoting competition and investment in fibre networks: Wholesale Fixed Telecoms Market Review 2021-26, Ofcom, 8 January 2020.

2.7 A RAB approach supports incentives to invest by allowing Openreach to recover fibre investment costs across a wider range of services, for example, from customers taking existing copper services as well customers who take up the new fibre services.

2.8 We discussed two variants of a RAB approach: a post-build approach; and a forecast approach.

- Under the post-build approach, Openreach only receives the additional revenue through higher charges once a certain amount of build has occurred (as measured by some deployment metric e.g. homes passed).
- Under a forecast approach, additional revenue to fund the fibre investment is allowed from the beginning of the control through higher charges based on a commitment by Openreach to deploy fibre.

2.9 While we considered that either of the RAB charge control options could meet our objectives, we expressed a preference for a forecast approach.

2.10 We considered the main challenge with a forecast approach was confirming that Openreach's investment commitments would be sufficient; and ensuring that Openreach delivers its committed investment programme.

2.11 We noted that BT/Openreach had suggested a forecast approach whereby legacy prices were CPI indexed. While we considered this had benefits, Openreach had not come forward with a firm roll-out plan in Area 3 at that time.

2.12 In the absence of deployment commitments from Openreach, we proposed to use a post-build RAB charge control.

The BT Commitment to deploy fibre in Geographic Area 3

2.13 On 26 June 2020, Openreach wrote a letter to Ofcom.[2] In that letter:

- Openreach referred to our January 2020 Consultation and to the possibility of extending our proposed approach to charge controlling WLA services in Geographic Area 2 to Geographic Area 3 should BT come forward with a sufficient commitment to build a fibre network in Area 3.
- Openreach confirmed its plans to commercially build out a fibre network (i.e. without public subsidy) to at least 3.2m premises cumulatively by the end of 2025/26. We refer to this as the BT Commitment.

This consultation

2.14 Based on our assessment and for the reasons set out, we consider that the BT Commitment provides a sufficient level of commercial fibre build to extend our proposed approach to pricing WLA services in Area 2 to Area 3 (i.e. under a forecast RAB).

[2] Letter from Clive Selley (CEO, Openreach) to Dame Melanie Dawes (CEO, Ofcom), 26 June 2020.

2.15 In this consultation, we set out:

- Our proposed approach to pricing WLA services in Area 3 (including our approach to assessing the BT Commitment).
- Our proposals for implementing a forecast RAB approach as part of the BT Commitment.
- Revisions to regulatory financial reporting proposals for WLA Area 3 in light of our forecast RAB approach.

2.16 This consultation should be treated as a supplementary part to our January 2020 Consultation and February 2020 Reporting Consultation.[3] Where stakeholders have made comments to those earlier consultations specifically about the forecast RAB approach, we have taken them into account and address them where appropriate in this consultation.

2.17 We will consider all stakeholder responses to our January 2020 Consultation; our February 2020 Reporting Consultation; and this consultation in preparation for our final decision in March 2021 and to the extent that such comments are not addressed in this consultation, we will pick these up in our decision.

2.18 We will publish the models used to support our proposals in this consultation shortly.

Strategic Statement Position

2.19 As required by section 2B (2) of the Communications Act 2003, we have had regard to the UK Government's Statement of Strategic Priorities (SSP) for telecoms, management of radio spectrum and postal services. In particular, we have had regard to the following priority areas covered by the SSP: world-class digital infrastructure, furthering the interests of telecoms consumers and ensuring secure and resilient telecoms infrastructure.

[3] Promoting competition and investment in fibre networks – BT Regulatory Financial Reporting, Ofcom, 6 February 2020

3. Our proposed approach to pricing WLA services in Area 3

Introduction

3.1 In this section we set out our proposed approach to pricing WLA services in Area 3. In summary our proposals are: [4]

- To adopt a forecast RAB approach.
- Pre copper retirement, to set charge controls on MPF and FTTC 40/10 rentals at CPI+0; and allow pricing flexibility on Openreach's FTTC services at bandwidths above 40/10 and fibre services (FTTP and G.Fast). [5]
- To restrict Openreach's ability to geographically target price reductions in Area 3 by prohibiting geographic discounts on FTTP rental charges in Area 3.

Our objectives in Geographic Area 3

3.2 We explain in our January 2020 Consultation our approach to remedies (Section 1, Volume 3) and our objectives for pricing regulation in Area 3 (Section 2, Volume 4). Our proposals continue to be based on this approach, which we recap below.

3.3 We consider that absent regulation, Openreach would have the incentive and ability to fix and maintain prices for WLA in Area 3 at an excessively high level and/or impose a price squeeze so as to have adverse consequences for end-users (including through a weakening of retail competition).

3.4 In Area 3, we do not consider there to be the potential for a material competitive dynamic. In the absence of such a dynamic Openreach will face weak incentives to deploy new and better networks. Therefore, our proposed approach to remedies in Area 3 is to promote competition through access to Openreach's wholesale services while also supporting BT's deployment of a fibre network.

3.5 We therefore propose to exercise our discretion in favour of an approach that sets appropriate incentives for BT to invest in fibre networks, while protecting consumers from excessive pricing (including through a weakening of retail competition). We consider this will best serve the interests of consumers, as the roll-out of fibre networks will deliver long term consumer benefits.

[4] All other proposals we set out in our January 2020 Consultation, including those relating to leased line services and dark fibre in Area 3, are assumed to remain unchanged.

[5] As set out in our January 2020 Consultation, post copper retirement we propose to set a charge control on FTTP 40/10 rentals only at the prevailing FTTC 40/10 price (plus a fibre premium of between £1.50 - £1.85).

Our general preference for a forecast RAB approach

3.6 As explained in our January 2020 Consultation, we consider that a Regulatory Asset Base (RAB) approach would meet our objective of ensuring consumers are protected whilst providing Openreach with incentives to invest.

3.7 In our January 2020 Consultation, we considered two variants of a RAB approach: a post-build approach; and a forecast approach. While we considered that either option could meet our objective, we had a preference for a forecast RAB approach.

3.8 Compared to a post-build RAB approach, a forecast RAB approach benefits from being relatively simple and transparent to implement.

3.9 The forecast approach has the benefit that Openreach gives an up-front commitment to build in Area 3 on a commercial basis and on a substantial scale. This provides a more direct and certain means of ensuring that consumers in Area 3 benefit from fibre than the post-build approach (since the post-build approach depends on incremental incentives that may not prove to be as effective).

3.10 Unlike the post-build RAB approach, where prices adjust as BT deploys its fibre network, the forecast RAB approach also benefits from providing customers with a predictable path of prices. This has benefits for retail competition since it provides wholesale customers with added certainty on legacy prices during a period when they will be considering migrating many of their customers onto fibre.

3.11 We also consider that a predictable path of prices will better support investment by alternative network providers in Area 3, where that is possible.

3.12 A forecast approach would also be less onerous as it involves imposing fewer restrictions on Openreach and reduces the risk that Openreach focusses exclusively on delivering the specified metrics at minimum cost.

3.13 In response to our January 2020 Consultation, stakeholders highlighted a number of challenges that are relevant to taking forward a forecast RAB approach. These were around the following broad issues:

- Having a commitment from BT on its build plans and being confident that it will deliver that network build accordingly.
- Monitoring BT's build plans in meeting its commitment and having measures if BT does not meet that commitment.
- Having an understanding of the costs and revenues relating to BT's fibre deployment (as part of assessing any commitment).

3.14 We agree that a key challenge to the forecast RAB approach is ensuring that the actual level of fibre deployment is consistent with the forecasts of fibre deployment used to set the charge controls. This is because where the actual level of build is lower than forecast, there is a risk of harm to customers due to excessive prices.

3.15 As a consequence, we consider that a forecast RAB approach should be backed-up by a commitment to deploy a fibre network. As explained earlier, Openreach has confirmed plans to commercially build out a fibre network (i.e. without public subsidy) to at least 3.2m premises cumulatively by the end of 2025/26.

3.16 While the BT Commitment to deploy fibre in Area 3 is a voluntary commitment (and is therefore not binding), we are confident that BT has the resources and incentives to meet that commitment. In May 2020, BT announced an ambition to deploy a fibre network to 20m premises by the mid to late 2020s. The BT Commitment to commercially deploy to 3.2m premises sits within that broader ambition. In this document we are making clear that the charge control proposals under the forecast RAB approach are founded on the understanding that Openreach will deliver on this commitment.

3.17 Nevertheless, we agree that monitoring BT's progress in meeting that commitment is important and we will expect Openreach to provide us with deployment plans in Area 3 to allow us to do this. Furthermore, we consider it is important to have measures in place to mitigate the risks to customers if BT does not meet that commitment. We set out our proposals around these issues in Section 4 and Section 5.

3.18 We agree that having an understanding of the costs and revenues relating to BT's fibre deployment is important for assessing the BT Commitment, and confirming that the proposals are cost reflective. In this section, we set out our proposed approach to assessing the BT Commitment.

Our approach for assessing the BT Commitment under a forecast RAB

3.19 Our proposed forecast RAB is aiming to allow the expectation of cost recovery across the fibre and copper network (over the lifetime of those networks). Therefore, we are aiming to understand:

a) What is a reasonable level of cost recovery that is required during the next charge control period (given BT's plans to deploy fibre in Area 3) that would allow an expectation of cost recovery over the lifetime of the fibre and copper network; and

b) Given this level of cost recovery, what are the appropriate levels for our CPI-X charge control over the next five years?

3.20 To answer question (i), we have estimated the shortfall in Openreach's investment case for its planned fibre deployment to 3.2m premises in Area 3 ("the fibre shortfall"). To calculate the fibre shortfall, we consider Openreach's incremental costs and revenues from building a fibre network to 3.2m premises, compared against the costs/revenues from continuing to operate the legacy (copper) network.

3.21 Importantly, to understand the level of cost recovery required during 2021-26 we also need to forecast the level of cost recovery in future periods beyond 2026. While we cannot fetter our discretion about the direction of future charge controls, the nature of this exercise is that we need to make certain assumptions about how regulation might evolve in future periods when we are dealing with investments which span multiple market review periods.

3.22 In terms of question (ii), the level of the CPI-X control under the forecast approach will be dependent on the level of fibre build that is planned. That is, all other things being equal, we would expect a higher set of copper prices (over five years of the control period) for higher levels of fibre build. As such, whether indexation (through extending our proposed approach to pricing WLA services in Area 2 to Area 3) or any other CPI-X control provides a reasonable level of cost recovery is linked to the level of BT's planned build in Area 3 under the BT Commitment.

3.23 There is a level of uncertainty around our cost and revenue forecasts (particularly since these stretch out over the lifetime of the network). Given this, we are not seeking to determine a single estimate of the level of cost recovery required during the next control period (and thereby a single level of copper prices needed to allow for that cost recovery). Instead, we first determine a reasonable range of cost recovery profiles that are consistent with an expectation of cost recovery over the lifetime of the fibre and copper network and then, for the reasons set out below, we then consider whether a forecast approach set at the level of CPI-0 in each of the five years (i.e. indexation) will provide a reasonable expectation of cost recovery for a planned fibre build to 3.2m premises.

3.24 Annex 2 sets out the modelling approach and assumptions we have used in more detail.

3.25 Based on our analysis, we estimate that:

- In deploying fibre to 3.2m premises in Area 3, Openreach will face a fibre shortfall ranging between £886m and £1,502m on a present value basis over 20 years.
- We estimate that additional revenues from indexed pricing during the charge control period 2021-26 will be around £313m under our central cost scenario (on a present value basis over the 5 years).

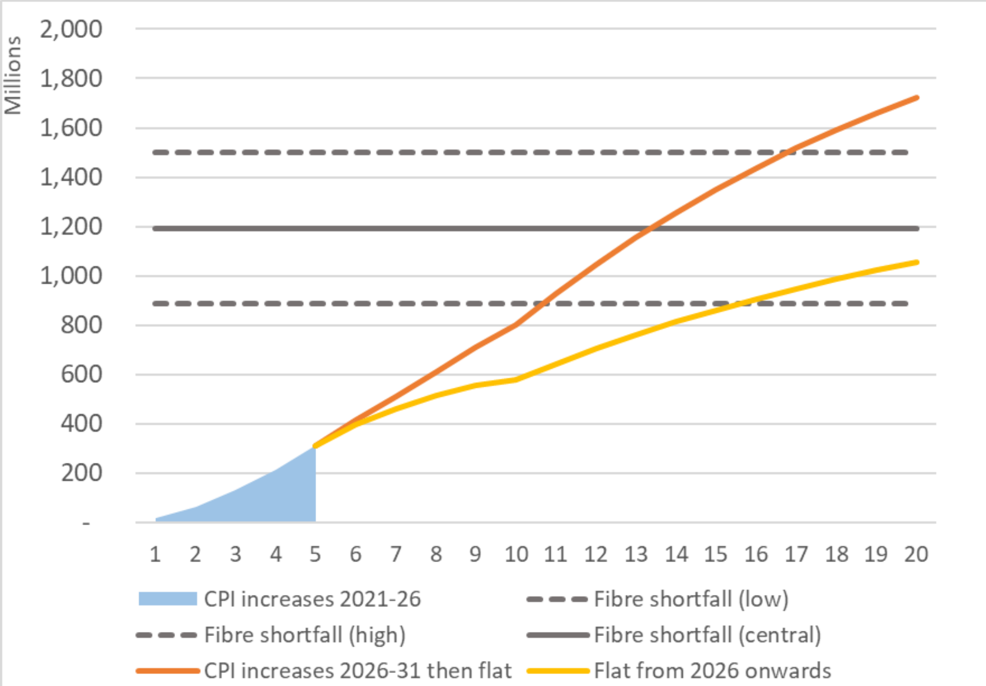
3.26 While there are other sets of prices that are potentially consistent with providing BT with an expectation of this level of cost recovery over the lifetime of the fibre and copper network (given its level of planned build in Area 3)[6], we consider that there are additional benefits to a forecast RAB approach that results in consistent pricing for WLA services across geographies.

3.27 Our proposed pricing in Area 2 is aimed at supporting competitive investment in rival networks, and also to support investment in Area 2 by Openreach. While we do not expect widescale competing fibre networks to develop in Area 3 to the same degree as in Area 2, a number of providers have indicated that they have ambitions to build in Area 3. Therefore, having a consistent pricing approach in Area 3 as in Area 2 would be supportive of network investment.

3.28 Therefore, we have considered whether indexing MPF and FTTC services at bandwidths up to 40/10 by inflation (and not charge controlling higher bandwidth services) from 2021 to 2026, sits within a reasonable range of profiles providing cost recovery when viewed over 20 years. Our estimates are presented in Figure 1 below.

[6] For example, relative to the proposed approach to pricing in Area 2, prices could be rebalanced across bandwidths, while still allowing for cost recovery.

Figure 3.1: Fibre shortfall and additional revenue estimates over 20-year investment lifetime (net present value, £m)



3.29 As shown in Figure 3.1, we estimate that under indexed pricing we would expect Openreach to earn additional revenue of between about £1,000m and £1,700m (in present value terms) over the next 20 years, with the range depending on the assumptions we have made for modelling purposes; that is, on whether prices will remain flat in nominal terms after 2026 or whether CPI increases are maintained for a further 5 year period (after which we assume they would remain flat nominal).

3.30 We are satisfied that the magnitude of this range is consistent with our fibre shortfall estimates and we note that we will have the ability to adjust pricing trajectories in future charge controls should it emerge that there will be a material risk of over- or under-recovery.

Our proposals

3.31 For the reasons set out above, we propose to adopt a forecast RAB approach. Under the forecast RAB approach, we propose:[7]

- Pre copper retirement, to set charge controls on MPF and FTTC 40/10 rentals at CPI+0; and allow pricing flexibility on Openreach's FTTC services at bandwidths above 40/10 and fibre services (FTTP and G.Fast).

[7] All other proposals we set out in our January 2020 Consultation, including those relating to leased line services and dark fibre in Area 3, are assumed to remain unchanged.

Protection of consumers on standard and basic superfast broadband

3.32 Under our proposals, price caps on MPF and FTTC 40/10 would be charge controlled at CPI+0. Therefore, customers taking these services would be directly protected from excessively high prices.

3.33 In our January 2020 Consultation, we expected a large proportion of customers to remain on standard broadband and 40/10 throughout the review period.

Protection of consumers on higher speed services

3.34 Under our proposals, we would be allowing pricing flexibility on higher bandwidths. This is a change to our January 2020 Consultation proposals under the post-build RAB approach.

3.35 In our January 2020 Consultation, we set out our view that, in Area 2, consumers on higher bandwidth products would be protected from the risk of excessive prices over this review period under the current level of price regulation. This was based on our view that the 40/10 price cap would be an effective 'anchor', constraining prices charged for higher bandwidths in Area 2. We acknowledged that the constraint imposed by a 40/10 price cap on higher bandwidth services would weaken somewhat over the review period, but considered that it would not be to the extent that it would not protect consumers from excessive prices.

3.36 We also identified factors which diminished the likelihood of price increases on higher bandwidth products over this review period, including the fact that wholesale prices of 80/20 and above will be constrained by the GEA discount contract, which has been signed by [✂], until 2023.

3.37 A number of stakeholders commented on this and we will consider these responses in our final decision. However, based on the evidence and analysis set out in the January 2020 Consultation, we consider that consumers on higher bandwidth products would also be protected from the risk of excessive prices over this review period in Area 3.[8]

Impact on competition at the retail level

3.38 Under our proposals we are allowing Openreach pricing flexibility on higher bandwidth products. This would mean that in theory BT could set high wholesale prices for those products relative to its retail price, leaving competing retailers largely dependent on selling the MPF and 40/10 based products alone.

3.39 In our January 2020 Consultation, we did not consider that this would pose a serious threat to the sustainability of retail competitors over the review period for the following reasons:

a) BT is required to provide network access on fair and reasonable terms, which addresses the risk of price (margin) squeeze.

[8] In our January 2020 Consultation, we also pointed to the increasing constraint that alternative network build will have Openreach's wholesale prices, and the constraint from Virgin Media's presence at the retail level, in Area 2. We acknowledge that these constraints are unlikely to be material in Area 3.

b) It is not clear that a margin squeeze strategy would be successful and may be commercially costly for BT. Setting high prices to other retailers may have some effect by moderating retail competitors' ability to compete for some consumers, but it would be unlikely to seriously damage their ability to compete in the market overall because 40/10 will be likely to remain a reasonable substitute for higher bandwidths, as well as the fact there are switching costs.

c) Market evidence is consistent with this assessment. BT has not been subject to price caps on its higher bandwidths, yet its strategy has been to offer discounts on the higher bandwidth products to encourage the largest retailers to sell more of these products, not less. These arrangements envisage discounts on the higher bandwidths to 2023.

Geographic discounts

3.40 In our January 2020 Consultation, we proposed restrictions on Openreach's ability to geographically target price reductions. In Area 2, the proposed restrictions applied to FTTC/G.fast, FTTP and leased lines rental charges, whereas in Area 3, the proposed restrictions applied only to FTTC/G.fast rental charges.

3.41 As noted above, a number of providers have indicated that they have ambitions to build in Area 3, with some rival investment taking place today. These providers have also argued that Openreach could use geographic discounts within Area 3 to deter rollout. While we do not expect widescale competing fibre networks to develop in Area 3 to the same degree as in Area 2, such build will bring value to consumers, for example, through greater or faster FTTP coverage and/or more choice.

3.42 Given this, we consider that there is a case for restricting Openreach's geographic pricing flexibility on FTTP rental charges in Area 3, consistent with our proposed approach in Area 2.[9] We are therefore consulting on an additional proposal to prohibit Openreach's ability to geographically target price reductions on FTTP rental charges in Area 3. We consider that the uniform pricing requirements on FTTP would apply within each geographic market (i.e. Openreach could apply a different uniform price in each area).

3.43 We recognise there may be circumstances where geographic discounts may be acceptable. Under our proposals, Openreach will be able to use the consent process discussed in our January 2020 Consultation to request use of discounts where they are objectively justified and consistent with our policy objectives.

3.44 In our final decision, we will consider stakeholder comments on this proposal alongside stakeholder comments on our proposals in the January 2020 Consultation.

[9] In relation to leased lines rental charges, we understand that alternative network build in Area 3 is typically focussed on FTTP. Even though providers tell us that they intend to serve leased lines customers, the lower leased lines volumes in Area 3 (compared to Area 2) suggest that this is likely to represent a smaller part of the business case.

Post-2026

3.45 BT's deployment of a fibre network is a long-term investment and the recovery of those costs will span beyond the forthcoming charge control period. Accordingly, while we cannot fetter our discretion, we anticipate that our proposed RAB framework will extend into future charge control periods.

3.46 Our proposed RAB is aiming to provide an expectation of cost recovery relating to BT's planned fibre deployment across the lifetime of the network. It is therefore a cost-based control (but considers cost recovery across both the fibre and copper networks) under which BT will have the ability to recover efficiently incurred costs in relation to both networks.

3.47 As such, in future charge control periods, we would anticipate regulating prices with regard to our typical considerations for setting cost-based controls. Therefore, we would expect to:

- Re-base our forecasts with reference to forward looking volumes, costs (and given our RAB framework forward looking revenues) to provide an expectation of cost recovery across the fibre and copper networks.
- Consider setting glidepaths to incentivise efficiency improvements.
- Set any charge controls by giving regard to allowing the fair-bet on BT’s investments.

We consider our proposed approach to be proportionate

3.48 When choosing the appropriate regulatory approach, our starting point is to ensure we meet our statutory duties. We explain in the January 2020 Consultation why achieving the objective will meet our duties. We also explain in the January 2020 Consultation and summarise above why our proposal for a forecast RAB charge control would be effective in achieving that objective and be the least onerous option for doing so. In that consultation, we also considered whether our proposed approach would have adverse effects that are disproportionate to our objective; specifically, whether competitive investment could take place in some parts of Area 3 and that cost-based legacy services together with a post-build RAB approach could stifle that investment.

3.49 We note that in response to our January 2020 Consultation, some stakeholders raised further concerns around this issue.

3.50 While we need to define the boundary for the purpose of our market analysis and will do that based on the best evidence available, we recognise that this may not perfectly reflect how rival networks are rolled out over the review period. We note that there are parts of Area 3 that are already served by operators such as Gigaclear and B4rn and that they may look to extend their networks during this period.

3.51 We consider that one of the advantages of our revised proposal for a forecast RAB and alignment of our pricing approach in Areas 2 and 3 is that this will provide the same support to rival network investors regardless of where they plan to build. We therefore consider that in this regard, our proposed forecast-RAB has an advantage over the post-build RAB approach.

3.52 We therefore continue to provisionally conclude that our proposals would not have adverse effects that are disproportionate to the aim pursued. Overall, we consider our revised proposals to be proportionate and appropriate in light of our objective.

Legal tests

3.53 We are making revised proposals on setting SMP conditions on BT in relation to the market for WLA in Area 3 to give effect to the proposed pricing remedies described above. Our draft SMP conditions can be found in Annex 1.

3.54 As explained above, we consider there to be a risk that, absent regulation, BT might fix and maintain prices at an excessively high level and/or impose a price squeeze so as to have adverse consequences for end-users (including through a weakening of retail competition).

3.55 As required by section 88 of the Act, we consider that the setting of the draft SMP conditions as revised by the proposals set out in this consultation would be appropriate for the following purposes:

Promoting efficiency

3.56 We consider that the proposed, revised charge control is appropriate for promoting allocative efficiency, since in the absence of potential competition, BT would have limited incentives to seek to reduce its prices of providing WLA services.

3.57 We consider that our proposed charge control encourages BT to increase its productive efficiency. This will be achieved by allowing BT to keep any profits that it earns by reducing its costs over and above the savings envisaged when the charge control is set.

3.58 In addition, the proposed charge control has been set to allow BT to earn a reasonable rate of return (cost of capital) where it is efficient.

Promoting sustainable competition

3.59 We have proposed a charge control that aims to support BT’s deployment of a fibre network while also promoting retail competition based on wholesale access to BT’s network.

3.60 While we do not consider there to be scope for material network competition in Area 3, we consider that the proposed charge control is supportive of rival investment to the extent that it emerges.

3.61 The draft, revised conditions aim to promote and maintain retail competition based on wholesale access to BT's network.

Conferring the greatest possible benefits on end user of public electronic communications services

3.62 The draft, revised conditions are intended to deliver the best outcome for consumers over the long term by incentivising fibre investment by BT where it would otherwise have weak incentives to deploy a fibre network. The draft conditions also protect end-users from excessive pricing.

3.63 We have also taken account of BT's investment in the matters to which the draft conditions relate by modelling BT's forecast costs for legacy services to allow for a reasonable rate of return on its investment (including mitigating the risks of stranded assets by bringing forwards cost recovery). The proposed charge control supports BT's investment in fibre networks where it would otherwise have weak incentives by ensuring that BT receives a sufficient return on its fibre investment.

3.64 On 22 July 2020 the Government confirmed its intention to transpose, among others, Article 74 of the EECC.[10] Article 74 amends the test previously set out in the Access Directive which section 88 of the Act transposes. This means that the test set out in section 88 of the Act will be amended before we issue our Final Statement. Article 74 requires NRAs, in determining whether price control obligations would be appropriate, to take into account the need to promote competition and long-term end-user interests related to the deployment and take-up of next- generation networks, and in particular of very high capacity networks. NRAs are also required to ensure that any mandated cost recovery methodology or pricing mechanism serves to promote the deployment of new and enhanced networks. We explain in detail in the January 2020 Consultation and above how we expect our proposed charge control to promote the deployment of new fibre networks, and why we consider this will be for the long-term benefit of consumers. We consider that our revised proposals continue to promote take-up of fibre since, in their absence, BT would have weak incentives to deploy a fibre network in Area 3 and it is unlikely that new fibre services would be available to customers in that area during the control period.

Section 47 tests

3.65 When imposing SMP obligations, we need to demonstrate that the obligations in question are based on the nature of the problem identified, proportionate and justified in light of the policy objectives as set out in Article 8 of the Framework Directive. For each draft SMP condition set out in this consultation, we consider that the conditions we are proposing to impose satisfy the tests set out in section 47 of the Act, namely that the obligation is:

- objectively justifiable in relation to the networks, services or facilities to which it relates;
- not such as to discriminate unduly against particular persons or against a particular description of persons;
- proportionate to what the condition or modification is intended to achieve; and

[10] See Annex A to the Government response to the public consultation on implementing the European Electronic Communications Code dated 22 July 2020

- transparent in relation to what it is intended to achieve.

Objectively justifiable

3.66 We consider that each of the draft SMP conditions we are proposing is objectively justifiable. The remedies that we are proposing are designed to address the competition concerns that we have identified in our market analysis (see our January 2020 Consultation, Volume 2). As explained in our January 2020 Consultation, Volume 3 Section 1, our provisional market analysis has found that Openreach has the ability and incentive to set excessive wholesale charges or, in combination with downstream prices, engage in a price squeeze behaviour (also referred to as "margin squeeze"). Consequently, we have identified where it appears to us from our market analysis carried out for the purpose of setting our proposed draft SMP conditions that there is a relevant risk of adverse effects arising from price distortion.

3.67 Therefore, in the absence of a requirement to provide network access, supported by associated obligations including charge controls, BT could refuse or impede access to its network, or it could provide access on less favourable terms and conditions compared to those obtained by its own downstream businesses. We are proposing to exercise our discretion in setting these obligations in favour of an approach that supports investment in fibre networks through promoting network competition in areas where this is economically viable, while protecting consumers from excessive pricing or a loss of retail competition in the short term and in areas in which network competition is unlikely to develop.

Not such as to discriminate unduly

3.68 We consider that each of the draft conditions does not discriminate unduly against BT. We are proposing that it is the only telecoms provider to hold SMP in the markets that we have identified and the draft conditions seek to address that market position.

Proportionate

3.69 For the reasons set out above, we consider that each of the draft conditions we are consulting on is proportionate to what that condition is intended to achieve. In each case, we are imposing an obligation on BT that: is effective to achieve our aim; is no more onerous than is required to achieve that aim; and does not produce adverse effects which are disproportionate to our aim.

Transparent

3.70 We consider that each of the draft conditions is transparent in relation to what is intended to be achieved. The text of the draft conditions is published in Annex 1 for consultation, and the operation of those conditions is aided by our explanations in this document. Our final statement will set out our analysis of responses to this consultation and the basis for any final decision that we take.

Ofcom's duties

3.71 The changes we are proposing to the SMP conditions proposed in the January 2020 Consultation have not changed our provisional view set out in that consultation that our proposed package of draft SMP conditions both individually and together meet our duties in sections 3 and 4 of the Act.

Consultation question

> Question 3.1: Do you agree with our approach to assessing the BT Commitment and proposals for pricing WLA services in Geographic Area 3?

4. Charge control design and implementation of forecast RAB approach with BT Commitment

4.1 In this section we set out our proposed approach to charge control design and implementation under the forecast RAB approach.

Charge control design

Duration of control

4.2 Consistent with the proposals in our January 2020 Consultation, we propose a 5-year charge control period.

Basket design

4.3 In our January 2020 Consultation, we set out our principles for basket design.

4.4 Under our proposed approach to charge controlling WLA services under the forecast RAB set out above, we are charge controlling MPF and GEA FTTC 40/10 rentals only.

4.5 Therefore, in contrast to our proposals in our January 2020 Consultation, we are not proposing to charge control FTTC rentals higher bandwidths (i.e. FTTC 55/10 and 80/20). As a consequence, our proposal in our January 2020 Consultation, to impose a basket control for GEA rentals (across all bandwidths) is no longer necessary.

4.6 In relation to MPF and GEA 40/10 rentals, we recognise that a single basket (combining both services) would provide more price flexibility to allow BT to recover common costs more efficiently (than separate controls). However, we consider that a separate control for MPF rentals will provide better customer protection to standard broadband customers since it will ensure that BT does not raise MPF prices as customers transition to higher speed services.

4.7 Therefore, we propose to set a single product charge control for each of:

- MPF rentals (Area 3 only); and
- GEA FTTC 40/10 rentals (Area 3 only).

4.8 This is reflected in the draft amended SMP Conditions (12B and 12C). In those conditions, references to the post-build RAB approach from January 2020 are removed.

4.9 Consistent with the proposed approach in our January 2020 Consultation, post-copper retirement we propose to switch our charge control from MPF and GEA FTTC rentals to GEA FTTP 40/10. We propose a single product charge control for:

- GEA FTTP 40/10 rentals (Area 3)

Specification of control

Compliance with build Commitment

4.10 While we fully expect BT to meet its commitment to deploy fibre to 3.2m premises in Area 3 by 2025/26, we recognise that there is a risk that it will not.

4.11 In the extreme case, where BT does not build fibre to any premises in Area 3, it will not have incurred any costs from deploying its fibre network but will have benefitted from copper prices being set above cost in order to support that fibre build.

4.12 We expect to gather information relating to BT's plans for deploying its fibre network as part of meeting its commitment. For example, we expect to gather deployment schedules and the planned locations of the fibre network. While this will help us monitor BT's progress with meeting its commitment, we would welcome views on whether any such information should be made public.

4.13 We are proposing that BT reports its progress in meeting its build commitment on an annual basis as part of its regulatory reporting requirements. In the event that it became clear that BT was not making progress in meeting its build commitment, we would look to re-open the charge control to avoid harm to customers (as a result of prices being above cost).

4.14 We consider that although BT may make all reasonable efforts to meet its commitment, there are nevertheless risks outside of its control that mean it is unable to meet its commitment fully. We are proposing to use accelerated copper depreciation to help mitigate the harm to customers where BT does not fully meet its commitment.

4.15 More specifically, to mitigate the risk of copper assets being stranded as a result of BT deploying fibre to 3.2m premises (and customers migrating from copper to fibre services), we propose to bring forward the full depreciation (and future return on capital) of copper assets capitalised since 2017/18 to 3.2m premises by 2025/26.

4.16 This assumption brings forward about a further £130m of cost recovery (including future return on capital) into the charge period relative to our proposals in January 2020.[11] We estimate this can provide a contribution to the funding of fibre deployment to about 1.3m premises.[12]

4.17 Therefore, if BT falls short in meeting its commitment for up to 1.3m premises, we can set lower prices for MPF and FTTC from 2026 to ensure that BT will not over-recover across

[11] In our January 2020 Consultation, to allow BT to fully recover its forward-looking capital expenditure on copper assets we proposed to accelerate the depreciation and return on capital profiles such that any additional depreciation that is required to bring those asset's net book value to zero after 2030/31 is recovered in the charge control period 2021/22 to 2025/26.

[12] In Section 3, we estimate that indexation relative to cost-based WLA prices allows for cost recovery of around £313m (NPV) over the five-year period of the charge control as part of the BT Commitment to deploy to 3.2m premises. We therefore assume that £130m of accelerated depreciation can fund fibre deployment to (130/313) x 3.2m premises.

the lifetime of the network (since those costs recovered via accelerated depreciation by 2025/26 cannot be recovered in future periods).

4.18 As such, customers will not face charges materially above cost (when viewed across the lifetime of the network). If BT does meet its commitment, we will be able to ensure it has the opportunity to recover its costs by rebasing the RAB for future charge controls.

Fit with public subsidy schemes

4.19 Although the details of a government subsidy scheme for the most difficult to reach areas have not yet been finalised, we do not believe that such a scheme will conflict with the proposed forecast RAB approach alongside the BT Commitment.

4.20 Under the BT Commitment, Openreach plans to commercially build fibre to at least 3.2m premises in Area 3 (i.e. without public subsidy). Therefore, Openreach’s fibre build that has been paid (or will be paid) through a subsidy will not contribute to meeting the BT Commitment.

Consultation question

> Question 4.1: Do you agree with our proposals for basket design and implementation of a forecast-RAB?

5. Regulatory reporting requirements

Introduction

5.1 In the February 2020 Reporting Consultation, we proposed regulatory reporting requirements for each of the markets covered by the January 2020 Consultation. In this section we set out amendments to the reporting proposals made in relation to WLA Area 3, taking account of our proposals discussed above.

5.2 Under the proposals in the February 2020 Reporting Consultation, BT must prepare Regulatory Financial Statements (RFS). These are prepared to a defined framework and methodology and include published statements as well as information that is not published but submitted to Ofcom privately. We proposed to impose SMP conditions supported by six directions.[13] We said that effective reporting should be relevant, reliable, transparent and proportionate[14] and our proposals were informed by these attributes and the approach to regulation set out in the January 2020 Consultation.

5.3 Our proposals in relation to WLA Area 3 included published information and information provided privately to Ofcom. We summarise these below and set out revisions to our proposals.

Revisions to our WLA Area 3 proposals

5.4 In Section 3 we explain that, given the BT Commitment to commercially roll out FTTP to at least 3.2m homes in Area 3 by the end of 2025/26, we propose to take a forecast (rather than post-build) approach to the RAB in WLA Area 3, where prices for MPF and FTTC 40/10 rentals are indexed to CPI.

5.5 The key changes proposed to WLA Area 3 controls in Section 4 are summarised in Table 5.1.

Table 5.1: Key changes to proposed WLA Area 3 controls

Product	January 2020 Consultation proposal	New proposal
MPF	CPI-CPI	CPI-0%
FTTC 40/10 rental	No specific control – part of FTTC rentals basket	CPI-0%
FTTC rentals basket	CPI-5.75% to CPI-15.0%	No FTTC rentals basket (no cost-based control for bandwidths other than 40/10)
MPF mark up	Prices marked up by a K-factor	No K-factor mark up

[13] Regulatory Accounting Principles direction, Preparation, Delivery, Publication, Form and Content Direction (‘form and content direction’), Consistency with Regulatory Decisions and Regulatory Asset Value Direction, Audit of the RFS Direction, Reconciliation Report Direction, Network Components Direction.
[14] Paragraph 2.5, February 2020 Reporting Consultation.

5.6 In light of the proposed move to a forecast RAB approach and changes to the proposed controls for MPF and FTTC, we have revised our reporting proposals for WLA Area 3 from the February 2020 Reporting Consultation which relate to MPF and FTTC services and the rollout of FTTP, in particular the requirements to:

- Publish service level information;
- Publish an additional note on FTTP rollout in Area 3; and
- Provide detailed information to Ofcom on the rollout of FTTP in Area 3 and investment in FTTP across Area 2 and Area 3.

5.7 We consider each of these below.

WLA Area 3 – published service level information

5.8 In the February 2020 Reporting Consultation, we proposed that BT must publish service level information for the following MPF and FTTC services:[15]

- MPF SML1 rentals (charge controlled only)[16];
- FTTC rentals basket, split into i) FTTC 40/10 rentals (charge controlled only) and ii) FTTC other bandwidth rentals (charge controlled only); and
- Other FTTC rentals.

5.9 We propose to maintain the requirement to publish information on MPF SML1 rentals as it is consistent with the individual control on this MPF product.

5.10 In the February 2020 Reporting Consultation, we said that although the proposed charge control on FTTC applied to a basket of all bandwidths, we proposed to require BT to report FTTC 40/10 rentals separately to enable stakeholders to compare trends across WLA Area 2 and 3 (i.e. FTTC 40/10 rentals would be reported in both markets). Similarly, we proposed to require BT to publish information on all FTTC rentals (split between the charge controlled basket and other FTTC rentals) to enable a comparison of all FTTC rental services across Area 2 and Area 3, e.g. to assess the outcome of BT's cost attributions between FTTC products between these areas.[17]

5.11 We propose to adopt the same approach to FTTC in this consultation. Given the proposal to replace the proposed control on a basket of FTTC products with a control on FTTC 40/10 rentals only, we propose to require BT to publish i) FTTC 40/10 rentals (charge controlled only) and ii) Other FTTC rentals. This is consistent with our proposals for Area 2 and would mean the same FTTC services are reported in both markets.

[15] For each of these we proposed that BT should publish revenue, volume, average price and cost information split between internal and external customers. See paragraphs 4.98 to 4.103, February 2020 Reporting Consultation.
[16] The 'charge controlled only' qualification is required since, once ultrafast is complete and a minimum of two years after the stop sell (triggered by ultrafast coverage exceeding 75% in an exchange area) controls on MPF and FTTC will be removed at premises where fibre is available. As noted in paragraph 3.5 of the June 2020 Copper Retirement Consultation, this means that when ultrafast coverage in an exchange is complete, Openreach will have pricing freedom on copper services where fibre is available (and hence it could be selling non-charge controlled MPF or FTTC) in some exchange areas.
[17] Paragraph 4.100, February 2020 Reporting Consultation.

5.12 The table below shows what we expect the service level information in the published RFS would look like from 2021/22 for WLA Area 3 and replaces that shown in Table 4.8 of the February 2020 Reporting Consultation.[18]

Table 5.2: Proposed service schedule for WLA – Area 3

Detailed service analysis Service	Internal Revenue £m	External Revenue £m	Total Revenue £m	Internal Volume	External Volume	Measure	Internal Average Price £	External Average Price £	Internal opex £m	External opex £m	Internal MCE £m	External MCE £m	Internal ROCE %	External ROCE %
MPF Rentals (SML1) charge controlled														
FTTC 40/10 Rentals charge controlled														
FTTC other rentals														
FTTP 40/10 rentals charge controlled (if applicable)														
FTTP 40/10 rentals non-charge controlled														
FTTP other bandwidth rentals														
Fibre Voice Access charge controlled														
GEA-FTTP 40/10 Transition charge controlled														
Ancillaries (CPI-0%, list where revenue > £5m)														
Ancillaries (£0 cap)														
Other ancillaries														
Other WLA Area 3														
Rounding														
Total WLA Area 3														

WLA Area 3 – published additional note on FTTP rollout in Area 3

5.13 In the February 2020 Reporting Consultation, we proposed that BT must publish a note containing a summary of the qualifying number of homes passed with FTTP (as at 31 October each year) and the revenue generated from the mark-up on MPF rentals. We said this would help stakeholders assess the impact and effectiveness of the remedies imposed (in terms of funding provided by the mark-up on MPF and how the rollout of FTTP develops in Area 3).[19]

5.14 We are retaining the proposed requirement for BT to publish a note on the number of homes passed as it would help us and stakeholders assess how FTTP rollout is developing against the BT Commitment. We propose that the rollout data should show the additions for the year and cumulative total as at 31 March each year.[20] As the BT Commitment relates to the commercial deployment of fibre to at least 3.2m homes, i.e. net of any government subsidies or other grants, we propose that the data published should relate to non-subsidised homes passed with FTTP.

5.15 We are no longer proposing a requirement to publish revenue generated from the mark-up on MPF rentals since we are no longer proposing a post-build approach to the RAB which would require a mark-up.

[18] For each service a breakdown of operating costs and MCE would also need to be provided as per our proposals in the February 2020 Reporting Consultation (paragraphs 4.52 and 4.53).

[19] Paragraph 4.105 and Table 4.9, February 2020 Reporting Consultation.

[20] The previous proposed requirement for information as at 31 October each year was to align the roll out data with the data used to inform the K-factor mark up. As we no longer propose a K-factor uplift we consider data as at 31 March to be more relevant since it corresponds to BT's financial year.

5.16 Table 5.3 illustrates what we propose this note would look like:

Table 5.3: Note on FTTP rollout in Area 3

	Measure	Additions for year	Cumulative total as at 31 March 20XX
Non-subsidised homes passed with FTTP	000s		

Private information

5.17 In the February 2020 Reporting Consultation, we proposed that BT should provide us with i) full details of the roll out of FTTP and K-factor mark-up figures and ii) information on incremental FTTP investment in Area 2 Area 3.[21] We consider each of these below.

Further details on the roll out of FTTP

5.18 In the February 2020 Reporting Consultation, we proposed that BT should provide us with full details and calculations behind the roll out and K-factor mark-up figures published in the RFS including:

- Total FTTP homes passed in Area 2 and Area 3, less homes passed funded by government subsidies
- Cumulative revenue generated from the K-factor mark up on MPF rentals

5.19 We maintain our proposal for BT to provide us with information on FTTP homes passed in both Area 2 and Area 3, split by those funded commercially and those funded by government subsidies or other grants. This would help us monitor that information published in the RFS is reliable and allow us to compare the roll out of FTTP between Areas 2 and 3.

5.20 In addition, we propose that BT should provide us with data on the number of homes passed with FTTP by exchange area. This would help us understand how BT's FTTP rollout evolves over time.

5.21 We no longer propose that BT should be required to provide us with information on the K-factor mark up because we are no longer proposing a post-build approach to the RAB which would require a mark-up.

Information on FTTP investment

5.22 In the February 2020 Reporting Consultation, we proposed that BT must provide us with a schedule setting out how much it has invested in FTTP networks in each of WLA Area 2 and Area 3 in each year and on a cumulative basis. We said this should include capital costs (by asset type such as duct and fibre) and operating costs. We also proposed that BT should provide us with FTTP revenues in Area 2 and 3.

5.23 We do not propose any changes to this requirement as we consider this information would help us understand the level of investment that is taking place, how this compares across

[21] Paragraphs 6.29 – 6.30 and Condition 11, Direction 2, Part 11 (i) and (ii), February 2020 Reporting Consultation.

geographic WLA markets and assess the effectiveness of the remedies imposed in Area 2 and Area 3.

Implementation

5.24 Our revised proposals have been reflected in changes to the proposed form and content direction. A marked-up version of the direction is shown in Annex 1.

Copper depreciation

5.25 In Annex 16 of the January 2020 Consultation, we proposed that, to allow BT to fully recover its forward-looking capital expenditure on copper assets by the time of copper retirement, any additional depreciation required to bring the assets' net book value to zero after 2030/31 would be recovered in the charge control period 2021/22 to 2025/26 (effectively meaning costs for those new copper assets would be recovered by 2030/31). To avoid over-recovery, we said we would not allow any further recovery of this capital expenditure post-2025/26. We said the impact of this proposal was to bring forward £1,400m (across Area 2 and 3) of nominal costs into the current review period.

5.26 In Section 4, we explain that, in light of the BT Commitment, we propose to further accelerate the depreciation and return on capital of copper assets capitalised between 2017/18 and 2025/26 for 3.2m premises in Area 3 to allow for cost recovery by 2025/26. This means that in Area 3, the costs of new copper assets associated with premises that are part of the BT Commitment would be fully recovered by 2025/26 while the costs of new copper assets associated with other premises in Area 3 would be fully recovered by 2030/31. We estimate that this would bring forward a further £130m of depreciation into the review period compared with our proposals in January 2020.

5.27 BT currently depreciates copper assets over 18 years or so.[22] For copper assets capitalised between 2017/18 and 2025/26, there may therefore be a mismatch during the review period between the copper asset life in the RFS and the copper asset life assumed for the purposes of recovering costs through the proposed forecast RAB approach in WLA Area 3. However, while we recognise that this mismatch could make it harder to interpret some aspects of the RFS, we consider that prescribing how BT should account for depreciation in the RFS for these assets would be inappropriately inflexible in this case. We note that BT could adjust its approach to copper depreciation in the RFS by making a methodological change to the RFS via the annual Change Control Notification process or by making a change to group policy in the statutory accounts (the effect of which would flow through the RFS). At this stage, we do not propose to prescribe via a direction how BT should depreciate these copper assets in its RFS. To the extent the RFS does not reflect our proposed approach to accelerating copper depreciation during the review period, we intend to publish in the statement our estimate of the additional depreciation and return

[22] For example, see page 57 of BT's 2018/19 AMD. BT may assume different asset lives for different classes of copper assets.

on capital brought forward into this review period for WLA Area 3, which could be used to assess the impact of our approach on WLA Area 3 costs and returns.

Legal tests

5.28 As noted above, our proposals have been reflected in changes to the form and content direction. Section 49(2) of the Act requires that Ofcom must be satisfied that any direction satisfies the test in that section, which requires directions to be objectively justifiable, nondiscriminatory, proportionate and transparent.

Preparation, Delivery, Publication, Form and Content of the RFS Direction

5.29 This direction provides details of the financial information to be included in the published RFS and to be provided to Ofcom privately. It therefore plays an important role in ensuring the RFS provide relevant information to stakeholders and Ofcom. Some elements of the published RFS relate to all of BT while others are specific to particular markets. To preserve the integrity and consistency of the RFS, we consider that all proposed SMP markets should be subject to appropriate reporting requirements.

5.30 We propose to give the Preparation, Delivery, Publication, Form and Content of the RFS Direction in relation to BT in each of the proposed SMP markets as set out in Annex 1. Edits to this direction reflect our proposals set out in this section. All other requirements of this direction remain unchanged from those included in the February 2020 Reporting Consultation.

Legal tests

5.31 We consider that the amended proposal for the Preparation, Delivery, Publication, Form and Content of the RFS Direction meets the tests set out in section 49(2) of the Act in that it is:

a) objectively justifiable because the information to be provided, both in public and in private, seeks to ensure that stakeholders have sufficient information about the products and services they purchase to provide them with reasonable confidence about BT's compliance with its SMP conditions and that we have sufficient information necessary to carry out our functions. This direction will ensure visibility of financial information for each proposed SMP market;

b) not unduly discriminatory in that BT is the only telecoms provider on which we propose to impose specific pricing and financial reporting remedies, as the only telecoms provider which we propose to find holds SMP in the markets concerned. We have explained in the February 2020 Reporting Consultation and in this document the reasons for requiring relevant additional information from BT both publicly and privately;

c) proportionate because the direction will be no more than is required to ensure the effectiveness of our proposals in this market review and will ensure that Ofcom and stakeholders are provided with a sufficient level of information; and

d) transparent because the intention of the direction is to make sure that the RFS remain fit for purpose and that Ofcom and stakeholders are provided with a sufficient level of information.

Ofcom's duties

5.32 The changes we are proposing to the Preparation, Delivery, Publication, Form and Content of the RFS Direction proposed in the February 2020 Reporting Consultation have not changed our provisional view set out in that consultation that the proposed accounting separation and cost accounting draft SMP conditions, and associated draft directions, both individually and together with the package of remedies proposed in the January 2020 Consultation (as amended by the proposals in this consultation) would meet our duties in sections 3 and 4 of the Act.

Consultation question

Question 5.1: Do you agree with our proposals for reporting requirements?

A1. Draft legal instruments

Draft legal instruments are available in a separate document.

A2. Our modelling and assessment of the BT Commitment

Overall approach

A2.1 In Section 3, we set out our proposal to adopt a forecast RAB approach. Under the forecast RAB approach, we propose:

- Pre copper retirement, to set charge controls on MPF and FTTC 40/10 rentals only at CPI+0; and allow pricing flexibility on Openreach's FTTC services at bandwidths above 40/10 and fibre services (FTTP and G.Fast).

A2.2 In reaching this proposal, we have undertaken modelling to understand:

a) What is a reasonable level of cost recovery that is required during the next charge control period (given BT's plans to deploy fibre in Area 3) that would allow an expectation of cost recovery over the lifetime of the fibre and copper network; and

b) what this means in terms of a CPI-X control for the next five years.

A2.3 The purpose of the modelling is to feed into the assessment of whether our proposals strike a reasonable balance between protecting consumers and allowing BT to recover efficiently incurred costs.

A2.4 As set out in Section 3, recognising the uncertainties around the modelling, we are not seeking to determine a single estimate of the level of cost recovery required during the next control period. Instead, we propose to assess whether indexation of WLA prices over the five-year charge control period, sits within a reasonable range of cost recovery profiles that are consistent with an expectation of cost recovery over the lifetime of the fibre and copper network.

A2.5 Our modelling comprises the following two calculations:

- The fibre shortfall: the shortfall in Openreach's investment case for its planned fibre deployment to 3.2m premises in Area 3 (relative to not investing); and
- The additional revenue from indexed pricing: the additional revenue from inflating MPF+FTTC 40/10 services at CPI and not charge controlling higher bandwidth FTTC services across all of Area 3 (relative to cost-based pricing).

A2.6 Our assessment considers whether the estimated additional revenue from indexed pricing during 2021-2026 sits within a reasonable range of profiles to reimburse the estimated range for the fibre shortfall over the 20-year investment lifetime.

A2.7 Below, we set out our approach and assumptions in calculating (i) the fibre shortfall, and (ii) additional revenues from indexed pricing.

Estimating the fibre shortfall

A2.8 Consistent with the approach in our January 2020 Consultation, to calculate the fibre shortfall we consider Openreach's incremental costs and revenues from building a fibre network to 3.2m premises and compare it to the costs/revenues from continuing to operate the legacy (copper) network. We assess the potential shortfall in Openreach's fibre investment case by examining the following components:

Figure A2.1: Methodology for calculating the fibre shortfall

Fibre build costs + Connection costs – Incremental fibre revenue – Net cost savings

A2.9 We have used information from Openreach's internal business planning documents and our own modelling of the costs of deploying a fibre network to estimate each of the components above.

Fibre build and connection costs

A2.10 We have calculated the capex costs of building the fibre network, connecting customers and running the network using our bottom-up full-fibre model published in January 2020.[23]

A2.11 Our bottom-up fibre model calculates the total cost of deploying and running a fibre network by estimating the number of network components needed to deploy the fibre network (e.g. civils costs, fibre, exchange equipment) and combining this with estimates of the capital and operating costs for each component.

A2.12 As in our January 2020 Consultation model, we have used the following assumptions:

- Geographic coverage: we have selected postcode sectors defined as Area 3 to calculate the specific build and connection costs in this part of the country. To estimate the fibre shortfall, we have calculated build and connection costs for 7.0m of the 8.8m Area 3 premises – excluding the 1.8m most expensive which are least likely to be covered by commercial build in this period – scaling this down to 3.2m on a pro-rata basis.
- Scorched node/Scorched earth approach: we model the costs on a scorched node basis which assumes the fibre network is deployed from the location of Openreach's existing access nodes.
- Re-use of physical infrastructure: we assume that Openreach reuses existing physical infrastructure, such as ducts and poles, where spare capacity is available and only builds new physical infrastructure where this is not available or feasible. We assume Openreach can re-use 70% to 80% of existing ducts and poles in its fibre deployment to Area 3.
- Connection costs: we have assumed a cost per connection of c.£280.

[23] No changes have been made to the bottom-up fibre cost model published in January 2020.

A2.13 Table A2.1 below sets out our estimates of build and connection costs for a 3.2m Area 3 deployment.

Table A2.1: Build and connection capex per premises passed for 3.2m Area 3 commercial deployment

Build type	Capex per premises (£)	Total capex (£m)
Build costs	370-490	1,170-1,560
Connection costs	280	790

Source: Ofcom bottom-up full-fibre model

Incremental fibre revenue

A2.14 To estimate incremental fibre revenue we have forecast both fibre take-up and the premium Openreach will earn from selling fibre services over copper services. We have updated these assumptions since the January 2020 Consultation.

A2.15 In the January 2020 Consultation, we assumed that there would be 90% take-up of fibre services after 5 years (with the remaining households being mobile-only). We have since updated this assumption to align with our latest volume forecasts for WLA services (set out below), leading to a more gradual profile of 90% take-up after 8 years.

A2.16 In terms of the premium that can be earned for fibre services over copper services, we have used information on operators' current and planned pricing to inform and construct a range.

- The bottom of the range is based on our proposed 'fibre premium' for the 40/10 FTTP anchor product and assumes that £1.50-£1.85 per month of additional revenue is earned for the full 20 years.
- The upper end of the range assumes that Openreach can set a price premium for higher bandwidth fibre services (for speeds above 40/10 FTTP). This is at a maximum of £4 per month for the first 10 years. After which, for years 10 to 20, the premium reverts to £1.50-£1.85 per month.

A2.17 Therefore, our modelling comprises fibre premium ranges of between £1.50 -£4.00 for the first 10 years; and between £1.50-£1.85 for years 10 to 20.

A2.18 In the January 2020 consultation, we assumed the modelled fibre premiums would rise with inflation. For consistency with our proposed 40/10 fibre premium, we now assume they are nominal.

A2.19 Consistent with the approach in our January 2020 Consultation, we have assumed that Openreach recovers £0 revenue from connection charges. This is based on [✂]. [24]

[24] Openreach slides entitled [✂""] provided to Ofcom on 29 July 2019.

Net cost savings

A2.20 We anticipate that Openreach could benefit from operating cost savings over the life of the fibre investment from being able to retire its copper network. These savings mainly relate to lower maintenance costs as the number of faults on the FTTP network will be significantly lower than on the copper network. We have also included the likely cost savings relating to the closure of copper local exchanges, such as accommodation and power.

A2.21 These cost savings will partially be offset by:

- Additional costs associated with setting up new systems to deal with FTTP connections, testing and maintenance, and the costs of installing and maintaining new OLT electronics at the exchange.
- Cannibalisation of BT's current leased lines revenues which may occur if some customers opt to migrate to FTTP services when they become available.

A2.22 Consistent with our January 2020 Consultation, we estimate a net cost saving per line of [✂] per month.

Summary of fibre shortfall estimates

A2.23 To calculate the present value of the fibre shortfall, we used our proposed pre-tax nominal WACC for other UK telecoms services (applicable to fibre services) of 7.9% to discount the cashflows: build and connection costs, incremental fibre revenue and net cost savings.

A2.24 In Table A2.2 below, we set out estimate of the range of the fibre shortfall based on the approach described above.

Table A2.2: Fibre shortfall estimates for 3.2m Area 3 commercial deployment

Scenario	Fibre shortfall (£m, NPV)
Low	886
Central	1,194
High	1,502

Estimating the additional revenues from indexed pricing

A2.25 To understand the expected additional revenues generated from indexed pricing (i.e. index inflating MPF+FTTC 40/10 services and not charge controlling higher bandwidth FTTC services), we have forecast revenues over the 20-year investment lifetime under the following scenarios:

a) Baseline prices: We assume MPF and FTTC (all bandwidths) prices would align with cost by 2026 via a glidepath, then remain at cost each year until our assumed copper switch-off date of 2031. Consistent with our fibre shortfall calculation, we assume FTTP prices will be £1.50-£4.00 per month higher than MPF/FTTC prices up until 2031. From 2031-2041, we assume the FTTP price will be £1.50-£1.85 per month higher than the MPF/FTTC price in 2031 and will remain flat in nominal terms throughout.

b) Additional revenue from indexed pricing: For 2021-26, we assume MPF and FTTC (all bandwidths) inflate with CPI each year until 2026 with pricing flexibility at higher bandwidths. For 2026-31, we have projected MPF and FTTC revenues under the following price paths, which gives us a range: (a) nominal flat prices; and (b) indexed to CPI (i.e. real flat).[25] As above, we assume the FTTP price is linked to the MPF/FTTC prices with a £1.50-£4.00 per month premium until 2031 and then a flat nominal premium of between £1.50-£1.85 thereafter.

A2.26 To calculate the present value of the additional revenue from indexed pricing, we used:

- our proposed pre-tax nominal WACC for Openreach (applicable to copper services) of 7.1% to discount the revenue earned on MPF and FTTC lines; and
- our proposed pre-tax nominal WACC for other UK telecoms services (applicable to fibre services) of 7.9% to discount the revenue earned on FTTP lines.

A2.27 In calculating the baseline scenario, we used an updated version of our CPI-X model. Since January 2020, we have made the following updates to the CPI-X model:

- **Start prices for 2021/22:** Our start prices, included in both the baseline pricing and indexed pricing calculation, are inclusive of GEA FTTC discounts – we gathered Openreach's forecast of revenues for 2020/21 and year-end volumes for 2019/20 and 2020/21 to generate average discounted prices for 2020/21. These average prices (including discounts) are used as the prices in 2021/22.
- **Base year cost data:** We have used 2018/19 restated RFS data and BTs 2020 Change Control Notification (CCN), corrected for known errors, to update the base year information to 2018/19.
- **Inflation:** Our forecasts are revised to reflect updated external cost indices evidence.
- **Volumes:** Since the January 2020 Consultation, there have been several public announcements regarding FTTP deployment in the UK, including Openreach's ambition to reach 20 million premises by mid to late 2020s. In light of these announcements, we have adjusted our modelling assumptions to increase the migration from FTTC to FTTP on Openreach's network. Furthermore, we have obtained updated WLA service volume information (2019/20 actuals and 2020/21 forecasts) which we have captured within our models to better reflect current product and bandwidth mixes.
- **Cumulo:** We have updated our estimates of BT plc's cumulo payments over the period in the light of more recent public information from the English, Welsh, Scottish and Northern Ireland governments about various matters such as rate poundages and

[25] These are assumptions used for our modelling only and do not represent regulatory proposals for future market review periods.

future revaluation dates. These revised estimates are almost identical to those we had previously. We have not updated our forecasts of how these forecast payments are attributed to services. We have therefore used our approach from January 2020 relating to attributions of cumulo costs.

- **Cost trends after 2026:** We have used a simplified approach to carry forward cost trends from 2021-26 by assuming opex inflation is CPI; and efficiency and cost volume relationship are assumed to be the same as those within the period 2021-26.

A2.28 Table A2.3 below sets out the assumptions used under our low cost, central cost and high cost scenarios for MPF and FTTC services:

Table A2.3: Low, Central and High cost scenario assumptions for MPF and FTTC cost modelling

	Efficiency	Opex inflation	WACC
Low cost	6.5%	2.0%	6.1%
Central cost	4.8%	2.0%	7.1%
High cost	3.5%	2.0%	8.1%

A2.29 To calculate the estimated additional revenues from indexed pricing, we subtract the present value of the baseline price scenario revenues from the present value of the indexed pricing scenario revenues.

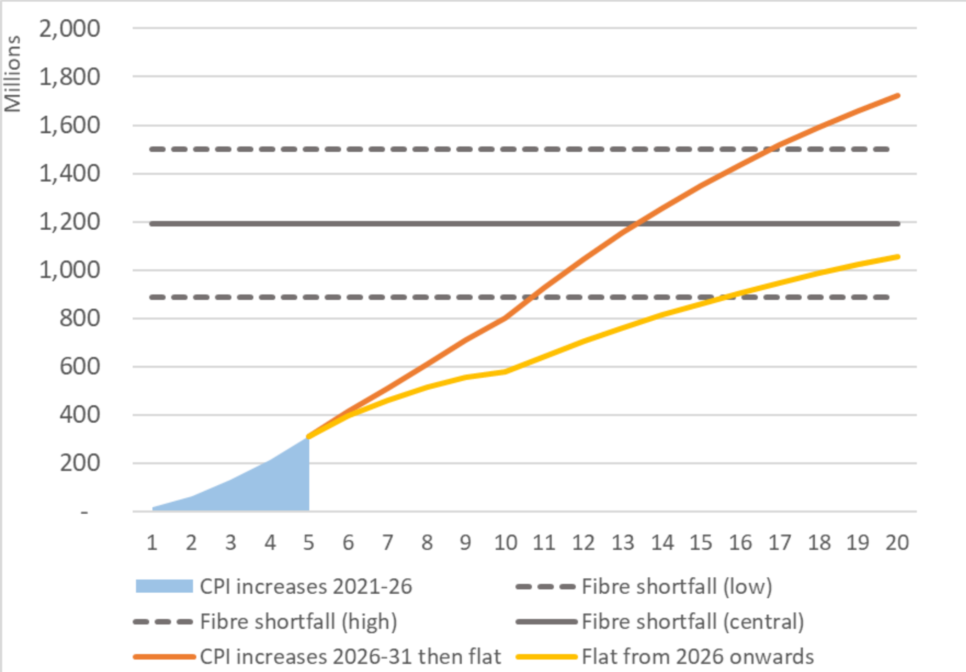
A2.30 Table A2.4 below sets outs out our estimates of the additional revenues from indexed pricing during the charge control period 2021-26 (on a present value basis over the 5 years).

Table A2.4: Estimates of additional revenues under indexed pricing during 2021-26 (Revenues £m, NPV)

	Baseline	Indexed	Additional revenue
Low cost	4,675	5,114	439
Central cost	4,769	5,081	313
High cost	4,885	5,044	160

A2.31 To understand whether this range of £160m to £439m of additional recovery for the 5-year charge control period sits within a reasonable range of profiles providing cost recovery over 20 years (given the fibre shortfall of between £886m to £1,502m), we have considered the following price paths for the remaining 15 year period: (a) nominal flat prices from 2026 to 2041; and (b) indexed to CPI (i.e. real flat) for 2026 to 2031 and nominal flat from 2031 to 2041. To illustrate, Figure A2.2 sets out our projections for our “central cost scenario” (£313m additional revenue for 2021-26).

Figure A2.2: Fibre shortfall and additional revenue estimates over 20-year investment lifetime for central cost scenario (net present value, £m)



A2.32 As shown in Figure A2.2, we estimate that for our central cost scenario under indexed pricing we would expect Openreach to earn additional revenue of between about £1,000m and £1,700m (in present value terms) over the next 20 years, with the range depending on whether prices will remain flat in nominal terms after 2026 or whether CPI increases are maintained for a further 5 year period (after which we assume they would remain flat nominal).

A2.33 The post-2026 pricing scenarios assumptions are used for modelling purposes only and do not represent regulatory proposals for future market review periods. We also note that we will have the ability to adjust pricing trajectories in future charge controls should it emerge that there will be a material risk of over- or under-recovery.

A3. Responding to this consultation

How to respond

A3.1 Ofcom would like to receive views and comments on the issues raised in this document, by 5pm on 16 September 2020.

A3.2 You can download a response form from https://www.ofcom.org.uk/consultations-and-statements/category-2/bt-commitment-area-3-fibre-network. You can return this by email to the address provided in the response form.

A3.3 If your response is a large file, or has supporting charts, tables or other data, please email it to wftmr@ofcom.org.uk, as an attachment in Microsoft Word format, together with the cover sheet.

A3.4 We welcome responses in formats other than print, for example an audio recording or a British Sign Language video. To respond in BSL:

- Send us a recording of you signing your response. This should be no longer than 5 minutes. Suitable file formats are DVDs, wmv or QuickTime files. Or
- Upload a video of you signing your response directly to YouTube (or another hosting site) and send us the link.

A3.5 We will publish a transcript of any audio or video responses we receive (unless your response is confidential)

A3.6 We do not need a paper copy of your response as well as an electronic version. We will acknowledge receipt if your response is submitted via the online web form, but not otherwise.

A3.7 You do not have to answer all the questions in the consultation if you do not have a view; a short response on just one point is fine. We also welcome joint responses.

A3.8 It would be helpful if your response could include direct answers to the questions asked in the consultation document. The questions are listed at Annex 6. It would also help if you could explain why you hold your views, and what you think the effect of Ofcom's proposals would be.

A3.9 If you want to discuss the issues and questions raised in this consultation, please contact please contact Keith Hatfield by email at keith.hatfield@ofcom.org.uk.

Confidentiality

A3.10 Consultations are more effective if we publish the responses before the consultation period closes. In particular, this can help people and organisations with limited resources or familiarity with the issues to respond in a more informed way. So, in the interests of transparency and good regulatory practice, and because we believe it is important that everyone who is interested in an issue can see other respondents' views, we usually publish all responses on the Ofcom website as soon as we receive them.

A3.11 If you think your response should be kept confidential, please specify which part(s) this applies to, and explain why. Please send any confidential sections as a separate annex. If you want your name, address, other contact details or job title to remain confidential, please provide them only in the cover sheet, so that we don't have to edit your response.

A3.12 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and try to respect it. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A3.13 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's intellectual property rights are explained further in our Terms of Use.

Next steps

A3.14 Following this consultation period, Ofcom plans to publish a statement in March 2021.

A3.15 If you wish, you can register to receive mail updates alerting you to new Ofcom publications.

Ofcom's consultation processes

A3.16 Ofcom aims to make responding to a consultation as easy as possible. For more information, please see our consultation principles in Annex 4.

A3.17 If you have any comments or suggestions on how we manage our consultations, please email us at consult@ofcom.org.uk. We particularly welcome ideas on how Ofcom could more effectively seek the views of groups or individuals, such as small businesses and residential consumers, who are less likely to give their opinions through a formal consultation.

A3.18 If you would like to discuss these issues, or Ofcom's consultation processes more generally, please email the corporation secretary at corporationsecretary@ofcom.org.uk

A4. Ofcom's consultation principles

Ofcom has seven principles that it follows for every public written consultation:

Before the consultation

A4.1 Wherever possible, we will hold informal talks with people and organisations before announcing a big consultation, to find out whether we are thinking along the right lines. If we do not have enough time to do this, we will hold an open meeting to explain our proposals, shortly after announcing the consultation.

During the consultation

A4.2 We will be clear about whom we are consulting, why, on what questions and for how long.

A4.3 We will make the consultation document as short and simple as possible, with a summary of no more than two pages. We will try to make it as easy as possible for people to give us a written response. If the consultation is complicated, we may provide a short Plain English / Cymraeg Clir guide, to help smaller organisations or individuals who would not otherwise be able to spare the time to share their views.

A4.4 We will consult for up to ten weeks, depending on the potential impact of our proposals.

A4.5 A person within Ofcom will be in charge of making sure we follow our own guidelines and aim to reach the largest possible number of people and organisations who may be interested in the outcome of our decisions. Ofcom's Consultation Champion is the main person to contact if you have views on the way we run our consultations.

A4.6 If we are not able to follow any of these seven principles, we will explain why.

After the consultation

A4.7 We think it is important that everyone who is interested in an issue can see other people's views, so we usually publish all the responses on our website as soon as we receive them. After the consultation we will make our decisions and publish a statement explaining what we are going to do, and why, showing how respondents' views helped to shape these decisions.

A5. Consultation coversheet

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing ☐

Name/contact details/job title ☐

Whole response ☐

Organisation ☐

Part of the response ☐

If there is no separate annex, which parts? ____

____

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here.

Name Signed (if hard copy)

A6. Consultation questions

Question 3.1: Do you agree with our approach to assessing the BT Commitment and proposals for pricing WLA services in Geographic Area 3?

Question 4.1: Do you agree with our proposals for basket design and implementation of a forecast-RAB?

Question 5.1: Do you agree with our proposals for reporting requirements?