



6 October 2017

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Dear [<]

Anti-Competitive G.Fast Overbuild and targeted pricing by Openreach in response to FTTP roll-out

It was good to meet with you and your team on 19th September. As you are aware, Vodafone continues to nurture ambitions to invest in Fibre to the Premises (FTTP), an objective that we assume Ofcom supports given its stated strategic goal of enabling three fibre networks in 40% of the UK. This would be a high value strategic investment for Vodafone with many risks, not least of which is the danger that our incumbent competitors may respond to news of Vodafone's entry into this product market with a destabilising strategy aimed at limiting the impact and success of new entry investments. The consequences of such a response being successful paint a sombre picture for UK consumers: investors run the risk of not having a genuine opportunity to generate a return on investment and their ventures fail, other potential investors will be immediately discouraged from investing in new networks and consumers are left with a limited choice of networks and providers.

As you know, Vodafone has consistently asked Ofcom to address its concern that BT, and Openreach specifically, has the ability and incentive to target its G.Fast investment in an anti-competitive way in order to thwart emerging competition. This has been a recurring theme of our communications with Ofcom over the past 18 or so months, and was highlighted in key submissions from Vodafone including on Ofcom's Strategic Review of Digital Communications. To date Ofcom has declined to respond positively to Vodafone's concerns. These concerns are now very real to Vodafone as we are on the cusp on considering how we can invest to secure more innovation for UK consumers.

Ofcom has an obligation to ensure that potential investors in fibre have a reasonable opportunity to make their investments work for them and their customers. This is clear from Ofcom's duty to promote competition in the communications sector. In fact, we believe that Ofcom has a positive duty to regulate now to achieve the dual objectives of encouraging investment and heading off a destabilising retaliatory response. We believe that a failure to act now will load disproportionate risk on would-be investors and the fibre ambition for the UK will be permanently grounded.

The asks that we discussed at our meeting – transparency of planned G.Fast rollout and high level G.Fast pricing obligations – are by no means onerous to implement, nor do they create disproportionate burdens on Openreach. Conversely, the absence of these protections is likely to unduly discriminate against investors in fibre and may well tip the risk/reward balance of the investment.

Our thinking, which we set out fully below, is this:

1. BT has SMP in this market, and Ofcom has a duty to further consumer interests.
2. Retail price competition is to be expected, but should not be facilitated by unconstrained upstream incumbent behaviour.
3. Our concerns are certainly not without merit – BT has form in responding to the threat posed by new entrants.
4. Our version of 'good' is extremely light touch: the asks of Ofcom are proportionate, not burdensome for BT, and limited only to what we consider is necessary to achieve the stated objective of encouraging investment in new fibre networks. The counterfactual – that is, a world where investment is too risky and consumers have limited choice of providers – is stark.

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BT (Openreach) has SMP in Wholesale Local Access markets

Our starting point is that Ofcom has the power to impose conditions on BT's conduct in this market: Ofcom has recently found that BT has SMP in Wholesale Local Access markets and is proposing to put in place a variety of regulatory obligations in order to safeguard consumers. These include obligations to supply, certain QoS obligations and pricing obligations on some of Openreach's products in this market.

Whilst the obligations proposed are clearly designed to promote the interests of consumers, there is one glaring omission relating to safeguarding competitive processes and competition more broadly, which in itself, is also designed to promote consumer welfare and choice. None of the obligations proposed protect competitors from strategic behaviour by Openreach which has the effect of throttling competition. Given that Ofcom has concluded that market entry is possible, and is indeed encouraging it, we are surprised that Ofcom has decided that there is no risk that Openreach, in its position of incumbency, will respond to that new entry by altering its existing commercial strategy in an effort to minimise the success of any alternative access networks. It is not simply enough for Ofcom to say that it encourages entry yet declines to take substantive steps through regulatory measures to do so. As a reminder, Ofcom has a duty both under the Communications Act and in Community law to promote competition in relation to the provision of networks and services, thereby promoting consumer choice and welfare. We are unclear as to how Ofcom has fully discharged this obligation in the circumstances.

While we are aware of the principles guiding Ofcom's regulatory actions, including the need to satisfy itself that it acts in cases where there is demonstrable need, we note that the application of this principle is not an exact science when dealing with incumbency and the scheme of ex ante regulation generally. Ex ante regulation is just that: it is regulation to account for circumstances which have not yet happened. To require that it is based on evidence of harm that has actually been incurred is fundamentally flawed – that is the role of ex post powers.

Moreover, the regulatory principles set out in Communications Act sub-section 3(3) really are just principles. They do not override or take priority over Ofcom's statutory duties but rather, are there to inform the performance by Ofcom of its duties. Abiding by the principles of regulation is therefore not an end in its own right.

Openreach-sponsored retail competition is ultimately bad for consumers

When we met, you raised the point that BT Consumer (or indeed another party) could respond to new entry with increased price competition and product offerings to consumers that ultimately divert customers away from the new entrant. You thus queried why wholesale regulation should protect against a response at retail level. The answer to this is very simple: retail price competition, while expected, should not be facilitated by strategic behaviour by an SMP wholesale provider.

More attractive wholesale pricing is a zero sum game for BT: the reduction in wholesale revenues resulting from a targeted and strategic price reduction secures increased take up at the retail level thus stimulating higher volumes of demand for the wholesale product. All pennies ultimately end up in BT's P&L. BT therefore has both the incentive and the ability to retaliate to the threat of new entry via targeted pricing and overbuild. It clearly has the incentive to limit and impair competition, particularly given its strategic decision to 'sweat' its existing copper assets rather than investing in new networks (a point we have raised with you now on a number of occasions).

Over the short run consumers clearly benefit from the retail price competition generated in these circumstances. However, it would be short-sighted of Ofcom to believe that this scenario serves the long-term interest of consumers because if BT is ultimately successful in harming and/or deterring new entry then price competition will be of limited duration and consumer choice will be limited.

Although Ofcom has not yet found SMP in retail broadband markets, analysis of BT's own Regulatory Financial Statements show that in approx. 800,000 households in WBA market A, BT has a 90% retail market share. There is a prime facie case for such a designation to avoid the situation of the Retail Voice Only market, where failure to intervene has led to high consumer prices. And while Ofcom has not yet found SMP in retail broadband markets, the opposite is true for wholesale local access markets.



BT has form when it comes to strategic responses to market entry

Vodafone's concerns are not without merit - BT has a track record of engaging antagonistically in markets to throttle competition.

In 2007/8 BT decided to take a more hostile approach in the market for wholesale end to end calls¹, taking aggressive action on pricing to win business and deter competition. It dropped its prices significantly (below interconnect costs on some contracts), with the result that it grew its market share from under 30% to one approaching 70% in less than two years (increasing to 90% if self-supply & Indirect Access are taken into account). The result of this behaviour was that BT's rivals lost the critical mass needed to compete at scale, with some suppliers exiting the market. Ofcom investigated this behaviour from 2008-2013 concluding that while margin squeeze had undoubtedly occurred, changing technologies in the market made it difficult to demonstrate actual harm from BT's actions. Although technological change has altered the shape of the market today for end to end calls, we have seen BT carry over its dominance into successor services (like IPX), where it remains unchallenged by any serious wholesale competition. BT's historic conduct has therefore had a lasting impact on the market and consumers more broadly.

Likewise, in the scale emergency call handling market (999/112), BT, with ~85% Market Share previously competed with much smaller rival Cable & Wireless, which had around ~15% market share. C&W successfully supplied emergency call handling to itself, Virgin Media and T-Mobile for a number of years. In 2011, following the creation of EE (through the combination of T-Mobile UK & Orange UK), the contract for EE's combined emergency call handling requirements was tendered, with BT aggressively discounting the price well below its published rates to win the business. This resulted in C&W losing the T-Mobile traffic and making the decision to exit the call handling market (as it lacked the scale needed to operate as a viable business). This market exit, prompted by targeted discounting by BT, handed BT ~100% market share. Needless to say targeted discounting has since ended, with prices rising as BT capitalises on its monopoly position to the detriment of its competitors.

A design for (light touch) regulation that is necessary, proportionate and not unduly burdensome

What do we feel that potential investors such as Vodafone need from Ofcom in order to support and promote investment in new networks? In summary, we need a limited period of breathing space to ensure that new entrants have a level playing field when competing for the consumer and we need transparency obligations imposed on BT to ensure they have little opportunity to strategically overbuild in areas where new entrant is occurring or is about to occur.

We have previously discussed with you how Ofcom might consider applying the proposed 'fair and reasonable' pricing obligations, such that targeted reduced pricing or other terms would not be considered fair and reasonable. This would be consistent with similar pricing policies in other markets. For instance, Ofcom has previously discussed permitting BT to vary its national pricing in BCMR markets where it could prove price differences were based on cost differences, otherwise national prices are expected.

Alternatively, Ofcom could put in place ex-ante price floors based on costs: this would require G.Fast build locations to be segmented into cost based zones, such that low cost builds were grouped together and therefore price floored accordingly.

Of course a national pricing obligation, which we have previously discussed, provides a very straight forward and simple obligation to implement and monitor and unlikely to be too interventionist, unless of course Openreach is planning to anti-competitively target third party network build.

Ofcom has historically provided BT with a free run in making speculative, risky investments, with both BT's initial FTTC investment only going ahead once regulation was modified in BT's favour in order to provide the service out of Openreach rather than BT Wholesale, and also to provide a significant regulatory pricing holiday. G.Fast investment is also proposed to go ahead without significant regulatory intervention.

¹ https://www.ofcom.org.uk/data/assets/pdf_file/0018/79011/final.pdf See: 5.42 – 5.47, Table 5.5 & 6.442



Third party fibre investment carries even greater risks, given that BT's behaviour in the market is a significant additional risk factor; we do not believe that our request for ex ante protection from anti-competitive behaviour is disproportionate or unwarranted.

We do not consider that the imposition of the obligations suggested above is burdensome for BT and, if Ofcom gets it right, then in fact consumers will benefit from greater competition in the medium to longer term. We envisage that any obligations will be imposed for a limited period of time necessary for consumers in a particular region to have the benefit of competing broadband providers and networks at the point that they are making decisions on broadband contract renewals. In practice this means that regulation, on a region by region basis, could exist for a period of, say, three years. This would enable new entrants to entice customers away from existing contractual commitments and to build a customer base of sufficient scale in order to offset at least some of the investment costs.

When we met, we briefly discussed the level of retail competition in York with BT Consumer competing aggressive to retain market share in the face of Sky and Talk Talk's fibre proposition. Ofcom cannot have failed to notice that there is no "York 2". The York commercial model and investment has not been repeated elsewhere. This may be due to the commercial construct of that deal, unmet stakeholder expectations or something else. What is clear is that the UK cannot afford many more failed attempts at fibre deployment without understanding why they are not more successful.

Why is regulation necessary? I think we have already given you a sense above of what hangs in the balance for investors and consumers if regulation does not support an already risky fibre business case. As mentioned when we met, ex-post competition law is clearly inadequate to constrain anti-competitive behaviour and doesn't present a timely solution for anyone. The evidential burden, the complexity of the case and time taken to address the matter all result in a very weak enforcement threat and remedies, that can by definition only be applied after the event has occurred. This is of no value to a damaged party which has decided on balance not to invest nor one which has withdrawn its investment. Could self-regulation be a credible alternative? We think not, certainly not when dealing with SMP markets.

Vodafone looks forward to understanding at your earliest convenience, what Ofcom is able to do to support fibre investment in the UK.

Yours sincerely

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