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By e-mail only

Dear James,

RE: BT Response to Ofcom's Initial consultation on the approach to modelling the costs of a fibre network

We agree with Ofcom that in light of the sizeable investment needed to upgrade the UK's broadband infrastructure so every consumer, citizen and business can benefit from it, Ofcom must equip itself to understand the costs of building FTTP under different deployment scenarios. We therefore welcome that Ofcom is consulting on its high-level approach to modelling the costs of a fibre network.

The purpose of the model, Ofcom says, would be *"to support [its] future regulatory decisions. Understanding the cost of deploying a fibre network will help us determine the likelihood of competition emerging in a particular area. It will also help us to design charge control remedies that fulfil the objectives we set out in our March 2019 Approach to Remedies consultation."* Openreach has been engaging separately with Ofcom on its model and is responding to this consultation. BT Group supports the points that Openreach makes.

In the following, we set out a number of considerations we think are important perhaps less in terms of the design of the model (given the many different ways this could be done); but more in terms of the potential uses Ofcom may make of the model and its possible limitations.

Ofcom appears minded to use the model to consider the fibre build case for a variety of potential types of fibre build (and associated business models), including but not limited to those of Openreach, altnets such as Cityfibre, Hyperoptic, or - in circumstances and geographies where it plans to build fibre - Virgin Media. Ofcom may expect the model to help it understand the viability of individual business models and build plans.

Ofcom also appears to signal that the model may help in designing future charge control remedies for Openreach full fibre build should these be required (by providing it with an understanding of the cost of full fibre build by Openreach and possible paths to cost recovery). No detail is provided on the circumstances in which the model might be used for this purpose. We note that the Fair Bet framework foresees pricing flexibility for at least two market review periods and that charge controls beyond that point depend on levels of competition and would, in any event, need to honour the Fair Bet. For now, what is charge controlled is the copper (and in future fibre) anchor.

A cost model alone is always going to be an imperfect tool to represent actual market dynamics, although it can be a valuable in understanding key interactions and dynamics for

example between cost, volumes and different cost recovery mechanisms in different competitive and deployment scenarios.

Below we set out some of the issues Ofcom should bear in mind when interpreting the results of the cost model and their implications for policy options. In particular, we think that important market dynamics are missing from the model. For example,

1. **The model appears to assume a level playing field resulting from Duct and Pole access.** This is welcome because we regard this intervention as removing the competitive advantage of network "ubiquity" (which Ofcom attributes to BT) for activities downstream of physical infrastructure. However, we are aware Openreach have been engaging with Ofcom to better understand the assumptions the model makes on the use of physical infrastructure in determining the cost of build by network operators building FTTP; as well as the assumptions around modelling approach (including but not limited to the scorched node or scorched earth approach). As such, we would expect greater clarity on the assumptions around physical infrastructure in the model to help demonstrate the level playing field the DPA access obligation creates between Openreach and other fibre builders.
2. **The model by definition ignores the impact on legacy assets of FTTP build (own or third party).** But any assessment of Openreach's cost of build in different parts of the country must acknowledge the impact on the recovery of legacy costs, in particular the effect of lower legacy volumes and shorter asset lives.
3. **Business only network providers (who may provide a competitive wholesale access inputs to FTTP providers (e.g. spine) are missing so their impact on consumers and the market (including as potential wholesalers of capacity) is not considered.** As we set out in our response to Ofcom's consultation on geographic market definition, and in our response to the remedies consultation, not considering this will lead to a distorted view of the degree of competition in the market for fibre build the dynamics of build.
4. **Business only providers aside, network operators with the ambition of large scale FTTP build do not have homogenous business models.** For example, the incremental build cost for FTTP (including unit cost per home passed) may be lower where certain costs (for example, of spine build) have been amortised through build to business premises first (including public sector, mobile backhaul or other anchor tenant type builds). Unless this is taken into account, there may be a risk of over-estimating the unit cost of build faced by altnets, in particular, as Ofcom proposes to model the cost of leased line build as an add on to FTTP and not the other way around.
5. **Some FTTP builders face a high option value of stopping build as and when costs rise in a postcode sector as they progress their build.** This may lead them to decide, after having commenced build, not to cover the entire postcode sector and to build elsewhere where build costs may be cheaper and/or demand greater, resulting in profitable cherry picking. Other network operators, such as Openreach with an existing large legacy customer base will have a much lower option value of stopping short of covering an entire postcode (or indeed exchange) area. This is because they would put at risk their ability to migrate their existing customer base and switching off the legacy network. Not taking this into account may also over-estimate the unit cost of build by altnets.

The above examples illustrate the complexity of market dynamics, build incentives and the nature of competition between different network operators.

Indeed, any model of a hypothetical operator is unlikely to match the costs and cost structure of a real world business with a strategy that evolves over time. We would, therefore, caution against the model being used to obtain point estimates including, but not limited to, regulatory pricing. This is due to the heterogeneity of business models identified above, but

also because the exact parameters feeding the model will vary depending on the circumstances (area of build, scale of build e.g. targeted or coverage of postcode area), levels of demand; and over time.

Investors will also look to update parameters as new information becomes available about cost and demand. This is particularly the case when investments are large, long-term, and largely fixed and sunk. For investors to be confident in the investment, the business will need the flexibility to respond to market developments (cost, demand, competition) to adapt pricing (so as to reflect optimal recovery of fixed and common costs over time and by geography).

We look forward to seeing Ofcom's concrete proposals. In the meantime, we would welcome the opportunity to discuss the above further.

Yours sincerely,

Tanja Salem