



BT's response to Ofcom's discussion document

“Strengthening Openreach’s strategic and operational independence

Proposal for comment”

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NON-CONFIDENTIAL VERSION FOR PUBLICATION

Comments on this response should be sent to:

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Consultant reports / advice

Analysys Mason	“Comparative analysis of outcomes in the UK broadband market: coverage, connections and competition” (published in full)
Compass Lexecon	“An economic analysis of Ofcom’s concerns and proposals” (published with redactions) “A review of CRA’s ‘The hold-up problem in vertically-related industries’” (published in full)
EY	“Openreach Consolidation” (CONFIDENTIAL – not for publication) “BT’s Regulatory Profitability” (published in full)
[REDACTED]	[REDACTED] (CONFIDENTIAL – not for publication)
KPMG	“Impact of Ofcom’s proposals for Openreach” (CONFIDENTIAL – not for publication) “Impact of Ofcom’s proposals for Openreach – Pensions Paper” (published with redactions)
PwC	“Consolidation report” (CONFIDENTIAL – not for publication) “Covenant considerations on BT’s 18 July offer to Ofcom” (CONFIDENTIAL – not for publication) “Covenant considerations on Ofcom’s 26 July proposal to reform Openreach’s governance” (published with redactions)
Telagè	“A Review of Ofcom’s Proposals to Impose Deeper Separation Remedies on BT” by Tony Shortall (published in full)
Freshfields Bruckhaus Deringer	Letter to BT dated 20 April 2016 (CONFIDENTIAL – not for publication)

OVERVIEW

1. As Ofcom acknowledges, consumers of broadband services in the UK are very well served by comparison with consumers in peer group countries, on a wide range of metrics – availability, take-up, speed and prices. BT has contributed to a very large extent to these outcomes through the bold and innovative large-scale investments it has made in Openreach.
2. In particular, via Openreach, BT has delivered the fastest large national scale deployment of superfast broadband in the world, achieving coverage of well over 25 million homes (nearly 90% of the country) with only limited public funding.
3. Equally, BT aspires to achieve ever improving customer experience at all levels of its business, including at the Openreach level and for all its Communications Provider (“**CP**”) customers, and is committed to working with Ofcom and the whole industry to drive further improvements in customer experience.
4. The UK fixed communications markets are recognised as amongst the most, perhaps the most, competitive in the world, with very low levels of concentration and the most successful record of entry by new competitors. The existing regulatory obligations to supply a suite of wholesale access products from an already functionally separate Openreach have been highly successful, and have delivered effective competition in the UK across downstream markets. Sustainable competition is growing rapidly at the infrastructure level. Neither Ofcom nor other CPs have provided evidence to demonstrate that BT has engaged in any anti-competitive discriminatory practice over the eleven years since the Undertakings that established Openreach were put in place (the “**Undertakings**”). Equally, no case has been made as to why discrimination may be a greater risk in the future than in the past.
5. BT and Ofcom agree on the broad set of objectives for strategic review, with a particular focus on investment, coverage and competition. On 18 July 2016, BT set out a package of measures that can deliver these objectives (the “**BT Proposal**”). The measures include substantial investment aimed at achieving better service, wider coverage and faster speeds. The package also included a notification to Ofcom of governance changes that will deliver a more independent Openreach with enhanced decision-making capabilities and powers. This proposal will deliver the benefits that Ofcom wants whilst avoiding the disproportionate costs and complexities that would result from Ofcom’s proposals. It will also allow to Ofcom bring the strategic review to a speedy, fair and sustainable conclusion that gives the industry the regulatory certainty and stability it needs to invest in the UK’s digital future.
6. Ofcom’s theory of harm is unfounded. The case is based on a perceived risk of “strategic discrimination” – i.e. that BT has the incentive and ability to invest in access networks that benefit downstream businesses within BT Group over investments that may support the strategic ambitions of competitors. However no past or prospective examples of such conduct are provided by Ofcom nor any explanation of how such discrimination could occur in theory. In this regard:

- a. No attempt has been made to consider how such decisions could be made given network competition from Virgin Media.
 - b. No reasoning is put forward to prove that BT's choices of strategic investments would not be aligned with the interests of other CPs who, like BT's downstream business, are reliant on Openreach inputs to address the **same** customer needs downstream and who gain access to such inputs on strictly equal access terms.
7. In short, no evidential or analytical case that such discrimination has occurred to date, or could occur in future, has been set out. BT's and Openreach's investments in the access network are driven by the need to respond to network competition and customer needs, both CP customers and end-customers, and this will remain the case going forward. No case has been put, or can be demonstrated, to the contrary.
8. Concerns around the availability of fibre to the premises ("**FTTP**") in the UK are also unfounded: BT's rapid and widespread deployment of fibre to the cabinet ("**FTTC**"), using VDSL2 technology, reflects a rational and ambitious forward-looking commercial assessment of market fundamentals in response to customer needs and competition, fulfilling government policy objectives, in the fastest large national scale deployment of superfast broadband in the world. BT's strategy has properly reflected the capabilities of different technology options in the UK context as well as customer demand and willingness to pay for increased access speeds (both now and in the foreseeable future). Such fundamentals would not be altered by changes to Openreach governance. The UK has 91% superfast broadband coverage and BT is on track to help the government achieve their 95% target by the end of 2017. FTTP is playing an increasingly important role in the deployment and as part of BT's commitment to bring ultrafast speeds to 12m homes and businesses in 2020.
9. Progress to address concerns around service standards has been made under the existing SMP framework. Minimum service level regulation has proven to be effective in driving service performance in a more balanced regulatory policy. BT welcomes the application of this approach to Ethernet products this year. The acknowledgement by Ofcom that separation options will not further the agenda on service improvements is also welcomed.
10. BT is committed to strengthening the functional separation of Openreach, to enable Openreach have greater independence in decision making. Ofcom's strategic review has been blown off course. Rather than focusing, as it set out to do, on the issues of great importance to the industry – how to promote investment and competition in response to ever rising customer needs and expectations – Ofcom has narrowed its focus to instead promulgate extremely interventionist proposals for the governance of Openreach which would be disproportionately costly and harmful to investment and innovation for the whole industry. The proposals set out by Ofcom (the "**Ofcom Proposals**") in its 26 July consultation paper¹ (the "**July Consultation**"), comprising "**Ofcom's**

¹ "Strengthening Openreach's strategic and operational independence"

Preferred Model” and **“Ofcom’s Alternative Model”**², would result in significant costs to BT,³ and would be detrimental to consumers in the UK.

11. Ofcom’s Proposals seek to insert a corporate veil between Openreach and the rest of the BT Group, which aims to establish Openreach as a distinct, incorporated company with independence and its own purpose (set out in its articles of association), assets and employees.⁴ Ofcom’s Proposals are akin to structural separation in all but name and legal form. If implemented, they would significantly curtail economic control by BT Group over the operation of the Openreach business, whilst leaving BT fully exposed to all downside risk, along with a range of other adverse consequences, even though Openreach would remain under BT ownership. Ofcom has failed to recognise the full extent of economic and implementation costs that would result if this model, tantamount to virtual structural separation, was implemented,⁵ including:
- a. Significant direct implementation costs would arise from creating the new company;
 - b. Significant increases in funding requirements for the BT Pension Scheme would result from a weakening of the covenant of the Group, owing to the reduction in economic control over a large part of the business and splitting the employee members between two companies;
 - c. The loss of economic control [✕], denying the shareholders their full rights to enjoy the proper benefits of ownership of the majority of their UK fixed assets, with a number of adverse consequences, that are discussed in Section 4 of this Response; and
 - d. Openreach considers all CP requirements and the associated margins when making investment decisions. BT is committed to providing the national infrastructure that Britain needs. In the early stages of a new technology deployment, such as the move from copper to fibre, not all CPs provide sufficient demand to enable a business case at the Openreach level. Ofcom’s proposals would make these crucial investment cases much more difficult: preventing BT from investing on the basis of end-to-end margins and with an anchor tenant committed to drive sales, as its main fixed infrastructure competitor Virgin Media is able to do. Instead, requiring Openreach to invest only by reference to Openreach margins would result in less investment given the particularities of the market which would prevent Openreach from obtaining an appropriate return for its investments.

² As set out at Section 2.2, below.

³ See, in particular, Sections 4.7 – 4.9 of this Response.

⁴ BT refers to this as **“full incorporation”** in this Response.

⁵ These are described in detail in Section 4 of this Response.

12. Loading BT with disproportionate costs, hampering its ability to control and deliver value from its key assets, and unduly constraining the development of business cases for and manage risks arising from major investments would adversely affect BT's ability to enhance and grow network capabilities in the interests of consumers through investment and innovation. These would be clearly perverse outcomes given that the central strategic challenge in the UK communications sector – reflected in the terms of reference set by Ofcom at the outset of its strategic review – is how to **encourage** investment sufficient to meet exponentially rising customer demand as soon as possible.
13. In the absence of a genuinely identified competition problem or market failure, it follows that introducing Ofcom's Proposals – with all the consequent cost implications – would represent a deeply flawed intervention that would deter investments by the largest investor by far in the sector and distort competition to the detriment of consumers.
14. Such a mandatory interventionist approach could not possibly be supported by the legal framework for imposing any form of functional separation and goes beyond Ofcom's statutory powers. Ofcom's Proposals are an ultra vires form of virtual structural separation. Moreover, Ofcom has not met the strict evidential and analytical criteria, required as part of a proper impact assessment in order to justify its proposed model as an exceptional remedy pursuant to ss. 89A and 89B of the Communications Act 2003 (“CA03”) which follow the provisions of Article 13a of the Access Directive⁶ (“AD”).
15. Furthermore, in putting forward its Proposals for Openreach, Ofcom has not given sufficient consideration to the BT Proposal, which puts forward a revised model of functional separation under s. 89C CA03 (and Article 13b AD. Although BT does not accept that Ofcom has any valid concerns, it has offered the BT Proposal as a voluntary regulatory compromise to address Ofcom's stated concerns, which it hopes will resolve this process in an expeditious way and enable BT to continue to focus on investment and driving improvements in customer experience at all levels of its business. The BT Proposal provides effective solutions for all of Ofcom's stated objectives, comprehensively and proportionately. It will establish an independent Openreach Board, a majority of whom would be independent of BT, who would be governed by Articles of Association imposing a core purpose to treat all customers equally. It will improve processes for customer engagement and deliver increased autonomy and transparency around decision-making within Openreach. It will provide all these enhancements to a regime which already works well without incurring the disproportionate costs of, and collateral damage inherent in, Ofcom's Proposals, and without depriving the shareholders of their rights of ownership or depriving the BT Group board of its ability to carry out its obligations responsibly.
16. The voluntary BT Proposal offers a comprehensive approach to take forward the UK telecommunications sector, building on the existing successful combination of SMP regulation under the CA03 and Enterprise Act 2002

⁶ Directive 2002/19/EC

(“EA02”) Undertakings, updated and revised to take account of the rapid developments in the market since 2005. Ofcom has failed properly to engage with the merits of the BT Proposal, both as a matter of substance and as a way to deliver a rapid and enforceable regime that addresses the concerns that it has raised.

17. Equally, Ofcom has failed to make any case for change from the current arrangements. Moreover, it has failed to establish why the significant additional costs of implementing its Proposals would be justified against BT putting in place the BT Proposal, which delivers all the substantive benefits Ofcom is seeking and which, importantly, preserves the benefits for end-consumers and the rest of the UK from BT Group’s vertical integration and protecting BT Group’s proprietary rights as the owner of Openreach.
18. BT and Ofcom agree on the outcomes for customers and the UK that Ofcom set out in their DCR. It is important that Ofcom makes their assessment with this in mind, enabling investment, competition and consumer choice and Britain to stay ahead in the digital world.

SECTION 1 - EXECUTIVE SUMMARY

1.1 Existing regulation and the current model of functional separation have delivered strong market outcomes for UK consumers supported by ambitious commercial investment by BT

1. Ofcom's 25 February 2016 statement "Making communications work for everyone: Initial conclusions from the Strategic Review of Digital Communications" ("**Initial Conclusions**") acknowledged that the UK has performed strongly against international benchmarks in terms of consumer outcomes. Since 2005, there has been rapid rollout of broadband services supporting strong downstream competition and choice. As a result, outcomes are shown to be good on measures of availability, take-up, average speeds, competition and prices for customers, and by comparison with other UK industries and our European peer group of countries.
2. Market developments have been supported by Ofcom's regulatory policies over the last 10 years, particularly by the Undertakings voluntarily offered by BT. The framework ensures that, where enduring bottlenecks are found in fixed line communications markets, access to these bottleneck services is supplied to all downstream players on strictly equal terms setting a level playing field for effective, efficient and innovative downstream competition.
3. Most notably, competitors utilising copper loops supplied by Openreach have entered the market over the last ten years. By pursuing differentiated strategies in downstream markets, LLU-based competitors have now reached over 40% market share (compared to BT's share of less than 40% share). Consumers enjoy a wide range of choice in how they purchase their broadband services: what headline speeds, what data usage allowances, what range of bundled services (voice minutes, TV content) to purchase together.
4. Market outcomes also reflect the bold large-scale investments BT has made, in particular to upgrade its Openreach access network capabilities over the last decade. BT has invested over £20bn in UK networks and over £11bn in Openreach's access and backhaul networks since 2005. This has included over £3.0bn of investment in upgrading the capability to deliver superfast access speeds to UK consumers and businesses, the majority of which was made on a purely commercial basis with no public support. BT's investments in superfast broadband began in 2008 with a series of trials followed by a programme of phased deployment across the UK which means that, as of today, over 25 million UK homes can access superfast broadband speeds.
5. Notably, BT's fibre network investments were made ahead of clear volume demand for such speeds or any understanding or evidence of consumer willingness to pay any premium over existing standard broadband access services. Openreach customers, such as Sky and TalkTalk, were unwilling to make any commitments to purchase new access inputs and support the economic case for the investment programme (as discussed in Section 3). The success of the case was, as it turned out, entirely dependent on sales by downstream BT to drive the revenues necessary to support the investment.

6. This example further demonstrates the effectiveness of existing regulatory structures and the importance of integrated and coordinated decision-making. Risky investment has been supported by a clear regulatory framework and policy certainty and by BT's ability to make co-ordinated investment decisions within the pro-competitive equal access framework.
7. Ofcom's regulatory policies have also provided the economic conditions in which competitors to Openreach have also been investing, particularly Virgin Media's commitment to rollout to another 4 million homes taking its coverage to over 60%, and also commitments by City Fibre Holdings, Gigaclear and Hyperoptic. CityFibre describes itself as the UK's largest alternative provider of wholesale fibre network infrastructure. Competition is sustainable and growing at all levels of the industry including the infrastructure level.

1.2 Specific concerns raised by Ofcom about outcomes to date are misplaced and do not support any change to the Openreach model

8. Two specific issues around outcomes to date have been highlighted as being of concern to Ofcom: service standards and the relative level of investment in FTTP.
9. We acknowledge that service standards, while improving, need to improve further to meet the standards required by customers. BT aspires to deliver ever improving services standards for customers. Improvements are needed at the Openreach level, downstream of Openreach and across the industry as a whole, with the support of regulation that prioritises customer service improvements.
10. We believe that some of the service issues at the Openreach level have arisen from the fact that Ofcom has adopted a one-sided policy of driving down costs of Openreach access lines for ten years. In the last decade, Ofcom has taken £1 billion of profit out of Openreach, and has only for one year so far balanced lower costs with an objective of promoting high service standards, supported by an allowance of £25m a year. We support Ofcom's current more balanced approach, now applied to Ethernet too, of driving up service performance through SMP regulation. Openreach has exceeded all of Ofcom's minimum service level requirements, which demonstrates that the use of SMP regulation is fully effective in addressing the issue. We agree with Ofcom's finding that separation of Openreach is not relevant to the question of service performance.
11. BT operates the largest FTTP network in the UK, albeit with only 330k premises passed. We believe four main reasons explain why FTTP has not had as high a share of deployment as we had expected when we began our superfast fibre roll-out programme in 2008/9 and/or when compared to other countries. First, it is five times more expensive and time-consuming to deploy FTTP than FTTC. Second, we have found very little revenue uplift from FTTP relative to speeds available on FTTC (only a 1%-2% increment to average revenues which, to date, has been insufficient to make a viable business case). Third, the UK has a much smaller proportion of premises in multi-dwelling units than in other countries, making it more expensive to deploy in this country. Fourth, mandated

equal access to FTTC at £7.50 a month provides negligible headroom for investment in FTTP.

12. The specific level of FTTP investment and roll-out by BT to date reflects rational and efficient investment decisions, taking full account of current and future demand from customers for higher access speeds, their willingness to pay and of technological capabilities and roll-out costs. Ofcom, itself, appears to accept that FTTP outcomes are unrelated to BT's vertical integration by acknowledging that underinvestment and other performance issues that arise solely from the exercise of upstream market power is not strategic discrimination (para. 6.59, Initial Conclusions). Relative figures on the availability of FTTP in different countries should be understood in the context of key market differences and should not be viewed in isolation from figures showing the overall availability of superfast services and extent to which demand is being met. Having noted all the above, BT is nevertheless committed to deploying a FTTP network past 2 million premises by 2020 and is constantly seeking a commercial basis for further deployment.

1.3 Ofcom's theory of harm that BT retains the incentive and ability to engage in "strategic discrimination" is solely based on assertion; this assertion is mistaken and unfounded

13. Ofcom's theory of harm is based on the assertion that BT has the incentive and ability to engage in "strategic discrimination" through its vertical integration and ownership of Openreach.
14. This concern is mistaken and unfounded. Ofcom has provided no evidence to support its concern, in particular there is no meaningful analysis of whether BT is likely to possess the ability and incentive to engage in strategic discrimination. BT does not consider that the network inputs provided by Openreach can be configured through investment choices in a way that gives systematic advantage to BT's downstream business over rival CPs. Key factors which are highly material to this assessment and which indicate that the concern is misplaced are:
- a. network competition: major investments which "shape the network itself" are made by BT in response to network competition and they are not confined to areas where BT faces competition as BT will implement its solutions more widely. Not only is BT's investment choice likely to be the best strategic response to competition for both BT and CPs, but BT and CPs have an equal opportunity to exploit the investment to deliver value to their respective consumers.
 - b. the nature of BT's major investments and their relationship to competition in the relevant downstream markets. The prospect of discrimination would only arise hypothetically where BT's downstream operations valued a network investment that was not valued by other CPs. However, that scenario does not arise in a market where there is effective retail competition as there is commonality of interests between BT and CPs in serving the same end-users and hence an alignment of

interests regarding the network investments needed to compete effectively. Even if a degree of customer specificity did exist, it is very unlikely that BT could make investment choices that would reliably and significantly disadvantage rivals given the scope for adaptation in rapidly evolving downstream markets.

15. Ofcom has not, therefore, demonstrated how strategic discrimination could arise or how it would be value creating for BT. The factors outlined above make it highly unlikely that BT would act on such a theoretical and speculative basis.
16. Equally, Ofcom does not provide any past or prospective examples of BT having made investment and/or portfolio decision decisions that involved strategic discrimination
17. Openreach's strategy and investment decisions are driven by the need a) to pursue its strategic goal of sustainable profitable revenue growth within its regulatory constraints, b) to satisfy end-customers, whose demand is growing exponentially, c) to earn revenues from its immediate CP customers by offering them services they wish to buy and which serve the interests of their customers and d) to compete with Virgin Media (and others, including 4G networks) by growing the capabilities of its network. All of BT's decisions at the Openreach level are consistent with these entirely legitimate and rational commercial objectives and there is no evidence to the contrary.
18. Ofcom does not claim that BT's decision in 2008 to invest in a fibre access network, largely based on FTTC technologies (a decision which shaped the network), is an example of strategic discrimination. Ofcom is right to have avoided any such allegation: in fact, this decision was based on the clear and objective drivers outlined above, and not by a desire to favour BT's downstream businesses. It is obvious today that end-customers' requirements of the network have been rapidly out-growing the capabilities of the copper broadband network. It was obvious even in 2008 that the Openreach network would struggle to compete with Virgin Media if it did not invest in a fibre network capable of comparable speeds. BT expected that all CPs would want to buy the fibre network products from Openreach. Its original business case made the assumption that volumes on the fibre network would mirror those in the broadband market as a whole, with BT retail operations achieving a share of about 30%, with other CPs making up the rest.
19. BT subsequently made a significant investment of £1.5bn, which soon increased to £2.5bn, in a time of global economic crisis and uncertainty. In the event, other CPs chose not to buy Openreach's fibre products in the volumes expected or as soon as anticipated. BT's own retail operations had to make up the shortfall in expected volumes needed to underpin the investment case. Each CP is free to adopt its own business strategy. Sky has succeeded in growing from a zero base to second in the retail broadband market by its bundling of broadband with pay TV products. TalkTalk has chosen to occupy a value position in the market and so was less interested in selling the fibre product. Those CPs chose to leave the risks of making the market in fibre broadband to BT but have subsequently launched fibre broadband propositions

and are competing aggressively. BT obviously cannot be held responsible for the actions of others in pursuit of their own strategic commercial goals.

20. We note that Ofcom also suggests that the current model presents a risk that alternative approaches to co-investment and risk sharing with other parties outside of BT Group may not be explored (although specific barriers are not specified). Ofcom does not, however, provide specific examples of the types of alternative arrangements it has in mind. Formalising risk allocation through contracts across multiple third parties in the context of large scale investments, the benefits of which will not be known for many years, presents a range of challenges. In particular, these models of investment are unlikely to be consistent with Eol requirements. In a nutshell, these models of investment are not as effective in mitigating demand risk and cannot easily be coupled with Eol requirements.
21. As regards portfolio decisions, all investments in Openreach are in networks whose services have to be provided on equal terms to all CPs. It is therefore effectively impossible to discriminate at the Openreach level. The only circumstances that might allow BT to discriminate at the Openreach level would be if BT bought services from Openreach that other CPs did not buy or if Openreach products served BT customers better than the customers of CPs. These circumstances do not arise because all CPs buy essentially the same inputs from Openreach, (i.e. copper and fibre connectivity) and all customer segments are served by multiple CPs using those equivalent Openreach inputs.
22. The only instance in which BT buys significantly different products from other CPs is the result of Ofcom's regulatory requirements. BT's downstream operations consume WLR while LLU operators consumer MPF for copper connectivity. If BT had the incentive and ability to discriminate, one would have expected BT to prioritise investment in the product BT consumes, WLR, over investment in MPF. In fact, one finds the opposite: BT is committed to withdrawing WLR completely by 2025.
23. Finally, Ofcom has provided no evidence of downstream market outcomes consistent with strategic discrimination: on the contrary, the evidence indicates that vigorous competition has emerged in retail markets as CPs have successfully contested market share in competition with BT using Openreach's access products.
24. In summary, it is insufficient for Ofcom simply to assert, without evidence or meaningful analysis, that BT has the incentive and ability to discriminate. No specific past or possible future instances of its strategic discrimination have been cited, nor is there any evidence that market outcomes reflect such a concern. The only conclusion, therefore, is that the regulatory regime (including equal access and functional separation), which has been in place for the past eleven years and which was specifically designed to prevent discrimination, has been successful. Ofcom has also failed to provide a cogent explanation as to why strategic discrimination may be a greater risk in the future than in the past in the face of clear factors suggesting otherwise.

- 1.4 The legal framework for mandating functional separation is clear and based on sound economic principles; the evidence does not support imposition of Ofcom’s extreme form of functional separation**
25. Ofcom’s Preferred Model – full legal independence and incorporation of Openreach – represents an extreme form of functional separation amounting to virtual structural separation. Openreach would become a separately incorporated company with full independence, de-consolidated from the Group’s balance sheet while remaining wholly owned by BT Group.
26. This proposal is beyond Ofcom’s powers. The legal route available to Ofcom to seek to impose this structure is set out in ss. 89A and 89B CA03 which reflect the requirements of Article 13a AD.
27. The evidential requirements on Ofcom to demonstrate the need for the imposition of the “exceptional measure” are clear. At a minimum, Ofcom would need to conclude that:
- a. existing SMP obligations had “failed to achieve effective competition”;
 - b. “there are important and persisting competition problems and/or market failures identified in relation to the wholesale provision of certain access product markets”; and
 - c. Ofcom’s Proposals are the most efficient solution, having taken into account all its implications for stakeholders.
28. Ofcom does not demonstrate that its strategic discrimination concern represents an “important and persisting competition problem”. The alleged issue is hypothetical and unlikely to exist in reality for the reasons set out above. Further, there is no justification for any concerns relating to the delivery of FTTP; Ofcom has not shown that FTTP outcomes in the UK represent anything other than commercial factors.
29. The evidence on market outcomes supports no finding of persistent competition problems. No case has been made, within any of the documents produced by Ofcom, that the Undertakings or SMP conditions have failed. It is notable, indeed, that other parties have acknowledged that there has not been discrimination in any market. BT’s compliance with the Undertakings has been extremely high at over 99.99%. Judging by market outcomes, the UK regulatory regime is the most successful of any member state. It is clearly not the case that Ofcom’s regulations have failed.
30. Furthermore, to implement full independence and incorporation Ofcom would need to submit a proposal to the European Commission for consideration and agreement. This would need to show, alongside the evidence justifying the need for the exceptional measures, that “there is little or no prospect of effective and sustainable infrastructure-based competition within a reasonable timeframe”.

31. All the evidence plainly shows growing competition at the infrastructure level and indeed at all levels of the value chain. Virgin Media competes in the self-supply of access to approximately 45% of all households and is already in the process of increasing this coverage to 60% of premises. New operators, such as CityFibre (targeting "second tier" cities), Hyperoptic (main cities) and Gigaclear (rural premises) are investing in their own access networks. Network based competition, therefore, is a significant threat to BT and is developing further.
32. Ofcom has declared that it wishes to see three parallel fixed networks covering at least 40% of premises in the country. BT does not believe that such a model is viable, least of all in the context of extremely effective regulation imposing equal access and low and declining prices for Openreach network products. Indeed, a survey of European countries provided with this response shows that only three countries in Europe are characterised by such a structure, and in all three cases this is for specific local reasons that are not applicable in the UK. In almost all cases, only two fixed networks are present in any one geography; one belonging to the former telecommunications incumbent and one from the cable operator. Indeed, the UK has one of the highest levels of coverage by more than two fixed access networks.
33. The specific requirements of ss. 89A and 89B/Article 13a should not be viewed solely as legal process matters. They reflect sound economic principles which must be applied when considering any form of regulatory intervention: i.e. they establish the need to show that a problem exists and that this problem could be proportionally addressed by the proposed regulatory remedy, as compared to alternatives. In other words, the costs the remedy would impose across the market must be shown to be outweighed by the benefits arising from fixing the problem. If no clear problem is established in the first place, costly ex ante regulatory interventions cannot be justified. Where, as in the case of functional separation, the nature and the consequences of intervention are significant, it follows that the burden of evidential and analytical proof required to justify the intervention should be high.

1.5 Ofcom's Proposals fail to take account of the full range of impacts that would likely arise and Ofcom fails to consider the relative merits of alternative approaches

34. Even if it were the case, which it is not, that, despite the existing SMP obligations (i) BT has the incentive and ability to strategically discriminate; (ii) that this has resulted in a failure to achieve effective competition and in important and persistent competition problems and/or market failures and; (iii) that there was little or no prospect of effective and sustainable infrastructure-based competition, it would then still be incumbent upon Ofcom under the terms of Article 13a(2):
- a. To analyse the impact of Ofcom's Proposals on Ofcom itself (its regulations in relevant markets), on BT (including its workforce), on investment incentives across the sector and on other stakeholders, including competitors and on consumers; and

- b. To provide analysis justifying that Ofcom's Proposals are the most efficient means to enforce remedies aimed at addressing the competition problems/market failures identified.
35. This requires Ofcom to consider the range of possible remedies including not only functional separation remedies but also the suite of SMP remedies available under Arts 9-13 of the Access Directive. Instead, Ofcom has leapt to its preferred remedy, the incorporation and independence of Openreach without properly considering either the status quo or the extent to which its residual concerns could be addressed by other means.
 - a. Ofcom has not made any connection, evidentially or analytically, between its flawed theory of harm and the specific remedy that it has in mind.
 - b. Ofcom has not sought to assess its Proposals against the status quo, nor against the BT Proposal nor against any other form of remedy.
 - c. Ofcom has not undertaken any cost benefit analysis across all affected stakeholders, to show that its remedy is a proportionate means of achieving its objective.
 - d. Ofcom has not made any effort to assess the negative consequences of its Proposals, in particular it has not assessed the adverse impacts, particularly to service and investment, of its proposed model.
36. The degree of independence and incorporation entailed by Ofcom's Proposals goes beyond the remit of Article 13a, which is confined to functional separation rather than structural separation and is therefore *ultra vires* Ofcom's statutory powers. In reality, Ofcom's Proposals would be profoundly harmful for the whole of the communications sector, because they would render Openreach, a crucial provider to all downstream CPs, a compromised business, removed from the direct signals and pressures of the retail market, less able to make the necessary investments to meet the needs of end-customers and less able to compete with end-to-end networks (such as Virgin Media).
37. BT's investment case for its bold (and risky) investment in fibre broadband networks showed a 12 year payback for BT Group. However, the payback at the Openreach level was 19 years because the margins at the Openreach level exclude the margins at the retail level. If Openreach had had to decide unilaterally whether to invest in fibre broadband simply on the basis of its own returns, at a payback of 19 years, it would not have been able to take such a risk. In the event, other CPs chose not to sell fibre broadband in significant volumes until three years after BT had launched. If BT's downstream operations had acted as other CPs did and waited for three years until selling it in volume, the Openreach case would have stretched further into the future, by about another five years, making the investment case non-viable. Major network investments of this kind require coordinated commitment and end-to-end margins in order to make the business case pay back.

38. This is not a specific case, but an illustration of the general case. If Openreach can only take into account its own margins then fewer and smaller investments will be made than if BT can take into account the end-to-end margins, because the downstream margins add to the returns used to recover the costs of the investment.
39. Further, an isolated Openreach may prioritise returns at the Openreach level, which may not result in investments in capabilities and services that are the closest match to the needs of the retail market, because it would not be able to take into account retail margins (which signal the value of investments) in considering its investment decisions in the way that BT currently can. This is adverse for all CPs, not just BT's own retail divisions.
40. It is also generally true that isolating Openreach, so that its investment decisions can only be made by reference to its own margins, will compromise its ability to compete with its main competitor, Virgin Media. Virgin Media makes investment cases on the basis of its end-to-end margins, across 100% of its retail customer base (because it does not offer any wholesale supply to its retail competitors), with a higher retail average revenue per user than BT's retail average revenue per user. An isolated Openreach will not be able to make cases to compete on such a disadvantaged and constrained economic basis.
41. In summary, Ofcom's Proposals are deeply harmful to the industry: Openreach would be significantly compromised, unable to invest to meet customer needs and unable to compete effectively.

1.6 Ofcom's Proposals will generate excessively high costs

42. The Ofcom Preferred Model, involving the incorporation of Openreach, removal of BT Group control and the transfer of people and assets would be extremely expensive to implement, costing multiple billions of pounds. Not only is this unjustified by reference to any identified competition problem, it would offer precisely zero benefits over the unincorporated Openreach solution proposed by BT. It therefore inevitably fails any cost benefit assessment. These adverse consequences cannot be alleviated by Ofcom's mitigation suggestions.⁷
43. The costs of Ofcom Preferred Model arise from many sources, but the overwhelmingly preponderant cost relates to pensions. Full incorporation, as envisaged by Ofcom, will compromise the covenant of BT Group, increasing the risks faced in the scheme by the trustees, giving rise to unnecessary costs measured in billions of pounds.
44. There would also be a number of adverse impacts from an employee perspective. Many of the changes proposed by Ofcom in their model would cause anxiety amongst employees and raise material employee concern. Employees would seek assurances about what the changes meant for them and expect the company and trade unions to protect their interests. The scale, and potential cost impacts highlighted mean BT would be unable to guarantee

⁷ See Sections 4.6 – 4.9 of this Response.

current employee arrangements which is likely to lead to uncertainty and potential industrial unrest. Indeed, the Communications Workers Union (which represents the largest group of employees in Openreach) set a union policy at their April 2016 conference to “*oppose by all means necessary including Industrial Action any attempts to sell off or turn Openreach into a BT subsidiary*”. Prolonged uncertainty or industrial action is highly likely to impact on customer service and investment programmes even with investment by BT to mitigate against the disruption.

45. In its Initial Conclusions document, Ofcom put forward 9 supposed benefits of incorporation, none of which represent actual benefits over and above the BT Proposal:
- a. Transparency – incorporation does not make the relationship between the parent and the subsidiary more transparent. Transparency arises from the regulatory requirement to operate the business separately.
 - b. Acting in the interests of Openreach – the requirement to act in the interests of Openreach does not arise from incorporation, but only from the regulatory requirement to do so.
 - c. Equal treatment in its Articles of Association – a company’s Articles of Association can only be enforced and can always be changed by its shareholder, BT in this instance. So adding the regulatory obligation into the Articles has no force other than that owing to the regulations.
 - d. Autonomy over use of capital – incorporation does not give a subsidiary autonomy over the use of capital. Such autonomy could only arise from regulatory obligation.
 - e. Finance without influence – it is completely infeasible for a public company to accept 100% of the risks arising from the investment of its capital while having no control over how that capital is spent.
 - f. BT benefiting from profits – incorporation does not give rise to this benefit, which is a benefit of ownership that BT already has.
 - g. Transparency of costs and assets – incorporation does not give rise to greater transparency of costs and assets. Openreach’s costs and asset base are defined by regulation and Ofcom controls the allocation methodologies already.
 - h. Benefits of vertical integration preserved – the benefits that are present in the current arrangements would be lost if Openreach was obliged to act as if not part of the vertically integrated BT Group, under the highly restrictive governance arrangements proposed by Ofcom. In particular this would give rise to substantially the same economic costs as structural separation which would increase the risk of upstream investments.

- i. Flexible boundary – the management of the boundaries between divisions of a single company is inevitably easier than the management of the boundary between legal entities, simply because it avoids the process of legal transfer of assets.
46. As well as the requirement to establish Openreach as a separately incorporated business within the BT Group, the second broad limb of Ofcom’s Proposals is the requirement for the independence of Openreach. Ofcom proposes that the only mechanisms of influence over Openreach left to BT would be: 1) the ability to set four parameters of the Openreach annual budget; and 2) the ability to appoint and remove the directors of Openreach, with Ofcom’s approval. The intent behind this ability for Ofcom to exercise a right to approve (or veto) the membership of the Openreach board appears to go beyond the usual “fit and proper” test required for individuals who hold a directorship. Furthermore, these mechanisms are plainly inadequate as a means to ensure economic control over Openreach and for the board to be able to fulfil its fiduciary duties to shareholders. It is infeasible for a public company to take all the risk arising from the use of its capital while having no control over how that capital is spent and limited ability to monitor and mitigate risks.
47. Such a construct would result in BT being [§<
-]. IFRS10 has three tests all of which must apply for a subsidiary to be consolidated: 1) that the investor (BT) has power over the investee (Openreach); 2) that it is exposed to variable returns and 3) that it is able to use its power to influence those returns. Ofcom’s proposal contravenes tests 1 and 3. Ofcom’s intention is that Openreach should have the greatest possible independence and should not be subject to BT’s influence. Consequently, BT would [§<
-]. It would deny shareholders their rights to enjoy to the fullest extent their ownership of the majority of their UK fixed assets. An inadequate ability to manage risks for which it is accountable may well result in BT being [§<
-]. This is an unwarranted and unsustainable intervention and one that is not within Ofcom’s powers under the European Framework to impose.

1.7 The voluntary BT Proposal represents a significantly more proportionate approach to the issues raised in the strategic review

48. In the absence of any basis upon which to impose Ofcom’s Proposals as a mandatory remedy, BT has nonetheless offered a voluntary solution to address Ofcom’s stated concerns. It has done so in the interests of reaching a sensible and expeditious resolution of this process and to enable it to continue to focus on investment, innovation and driving improvements in the customer experience at all levels of its business. The BT Proposal, elements of which have been welcomed by Ofcom, provides a comprehensive, effective and proportionate response to the issues raised in Ofcom’s review in relation to Openreach governance and independence. The model will help to accelerate Britain’s digital future by giving Openreach more control of its strategy,

investments and plans all with the benefit of greater transparency, particularly with regard to decision-making on major new investments in the network. By these means, Openreach can deliver better service, even wider coverage and faster speeds to customers through investment in new services. Such developments will help maintain the UK's leading position amongst the world's digital economies.

49. However, the BT Proposal does not give rise to the significant economic costs associated with Ofcom's Proposals because it permits Openreach to remain an integrated business division within the BT Group. It allows BT to continue to build investment cases and take on risk on an integrated basis. The BT Proposal maintains BT's right to retain ownership and enjoy any profits from its investment, but in a delegation framework that provides a reasonable balance between the duties of its Board of Directors to the shareholders and the objective of securing a high degree of independence for Openreach within the broad terms of the financial envelope set by BT as part of its supervisory prerogative. It would enhance the core principle of equal treatment between all downstream customers of Openreach and strengthen the approach to customer consultation. In the face of increasing network competition and the need to develop the capabilities of the network to meet the needs of end users, BT is committed to open engagement with its customers that will help shape strategic and commercial approaches around investments, product development and pricing structures.
50. The proposed BT model therefore supports and reinforces key principles, but avoids the unnecessary and unjustified costs that are driven by the preferred Ofcom model. It is an inherently more proportionate response to the issues that have been raised by the strategic review.
51. Ofcom has welcomed elements of this proposed model, but ultimately provisionally dismisses it on the basis that it fails to deliver the full independence for Openreach that Ofcom wants to see. However, in so doing, Ofcom has failed to assess the BT Proposal by reference to costs and benefits alongside its own Proposals.

1.8 Ofcom cannot measure success against actions outside of BT's control

52. Ofcom is suggesting that structural separation may remain an "option" while it assesses the impact of whatever Openreach model is implemented. BT rejects the assertion that structural separation is an option for Ofcom: it is not a remedy available under the European Regulatory Framework ("ERF") and is incompatible with the provisions of the ERF.
53. BT is concerned that Ofcom intends to maintain a watching brief on the success of whatever model may be introduced by reference to a wider set of market outcomes, many of which will be outside of BT's direct control.
54. BT can only be legitimately measured against the steps it itself takes to implement the model and to ensure it is operated in a compliant way. For instance, if downstream CPs fail to engage with Openreach when structures

are in place to allow them to do so on a confidential basis or if any engagement fails to identify new commercial opportunities of mutual benefit to both parties, then this cannot automatically be viewed as a failure on BT's part or of the model itself. In fact, the more logical conclusion to reach, subject to firm evidence to the contrary, is that market outcomes reflect efficient investment and pricing decisions at that time.

55. While it may be understandable that the regulator will want to monitor the broader impacts of the model introduced alongside the implementation of other measures arising from its strategic review, this must not be framed in the way set out in its July Consultation – i.e. in a way that risks creating a prolonged period of continuous uncertainty which will further damage the BT covenant, driving increased pensions costs, and undermining investment incentives.

1.9 Concluding comments

56. BT was supportive of the core objectives of Ofcom's strategic review when they were set out: regulation must be applied in a way that supports ongoing investment and innovation and drives the best outcomes for UK consumers. But Ofcom has lost the wood for the trees by focussing solely on the nature of the governance arrangements for Openreach. The case for change to implement Ofcom's Proposals has not been made and cannot reasonably be made by reference to available evidence and sound economic analysis, because the theory of harm is speculative, unproven and contradicted by prima facie evidence and because Ofcom's Proposals are likely to drive disproportionate costs and denial of ownership rights.
57. The voluntary BT Proposal, already notified to Ofcom, will enhance the current benefits arising from Openreach's provision of a suite of access products on an equivalent basis and establish a refreshed model that will continue to support efficient, effective and innovative downstream competition in the provision of standard, superfast and ultrafast broadband services to the benefit of UK consumers.
58. BT's Proposal reflects both the statutory regime at both UK and EU level and a proportionate incremental approach that builds on the successes that have been achieved since 2005. By contrast, Ofcom's Proposals do not respect the statutory limits of that regime and represent an unjustified and disproportionate regulatory response that would harm rather than benefit not only BT but the wider UK market.

SECTION 2 - CONTEXT

Overview

2.1 Chronology

2.1.1 The First Strategic Review and the Undertakings

1. In 2005, Ofcom conducted its first strategic review which resulted in BT giving Undertakings, creating Openreach as a functionally separate part of the BT group and the introduction of the equality of access regime. These Undertakings addressed concerns identified by Ofcom in relation to possible discrimination by BT and were given pursuant to s. 154 EA02 in lieu of Ofcom making a market investigation reference to the then Competition Commission.
2. The purpose of the Undertakings was to address certain features of the market which Ofcom believed gave rise to concerns about competition in the upstream market for the provision of network access and backhaul network services, and specifically Ofcom's belief that, because of its ownership of the network division upstream and vertical integration to retail operations downstream, BT had the incentive and ability to discriminate in the supply of its wholesale access services.
3. Among other things, the Undertakings:
 - a. require BT to provide certain products and services to CPs on an equal access or "Equivalence of Inputs" or "Eol" basis;
 - b. provide for organisational changes within BT, including the creation of Openreach as a functionally separate business within the BT Group to supply certain wholesale products. The Undertakings require, among other things, that the Openreach offices and its management team are separate from the rest of BT and it uses a different brand. Openreach must also use Chinese walls to ensure that there are no inappropriate disclosures into BT downstream divisions of competitors' confidential information or confidential information about its regulated products, and ensure that its IT systems are virtually and/or physically separated from the rest of BT; and
 - c. provide that compliance with obligations accepted by BT in the Undertakings (both Eol and functional separation) is monitored by the Equality of Access Board ("**EAB**"). Ofcom described this as an "*independent, authoritative and transparent board within BT*" which provides transparency through the publication of an annual report. Ofcom noted that the EAB would be able to address its concern that in

a vertically integrated company, non-price discrimination can be harder to detect than price-discrimination⁸.

4. Ofcom's conclusion in 2005 was as follows:

“The undertakings are apt to address the competition concerns identified, because whilst they allow BT to retain its vertically integrated structure, they set out a detailed basis on which BT can operate within the context of its market power and vertical integration; and they constrain its ability and remove the incentives of its component divisions to engage in the types of conduct identified which have the effect of restricting competition.”⁹

In other words, they addressed exactly the same issues as are being considered now.

2.1.2 The Second Strategic Review

5. Approaching the 10 year anniversary of the Undertakings in March 2015, Ofcom decided to carry out a second broad strategic review and published its terms of reference, stating that:

“The aim of this review is to make sure communications markets continue to work for consumers and businesses. The review will focus on three overarching questions:

Efficient investment: *How can incentives for efficient private sector investment and innovation be maintained and strengthened, to ensure widespread availability and high quality of service?*

Competition: *What should be the focus of competition policy in future networks (the 'enduring economic bottlenecks')?*

Deregulation: *What is the scope for deregulating networks and services downstream of any 'enduring bottlenecks'?*”

6. Ofcom summarised the wider market context in its July 2015 consultation, as follows:

“In fixed telecoms, Ofcom's first strategic review resulted in the creation of Openreach as a functionally separate entity from the rest of BT. Openreach is responsible for operating the 'last mile' of BT's access network on behalf of all communications providers. Competing providers could now access BT's network on equal terms, and this contributed to one of the most competitive broadband markets among major European economies. The average price of a residential fixed broadband package has fallen by 40% in real terms between

⁸ Ofcom's Section 155 EA02, Notice of 30 June 2005, paras. 5.53-5.57.
<http://stakeholders.ofcom.org.uk/binaries/consultations/sec155/summary/sec155.pdf>

⁹ Ibid, para. 5.17.

2004 and 2014, and take-up of superfast broadband in 2013 was double the average of the other four major European economies". [Footnote references removed]

7. Similarly, Ofcom pointed to success stories in mobile, with prices falling by two thirds between 2003 and 2012, new market entrants, and technological and service delivery innovation. These successes are in contrast to the evident and enduring competition problems that persist on pay TV, problems that Ofcom has failed to address.
8. So it is evident that, at the outset of this review, Ofcom was taking a broad strategic overview of the communications sector, where key issues around future investment and competition were under consideration. The responses to the 2015 consultation revealed that there is much common ground between Ofcom, BT and other industry stakeholders: in particular that, notwithstanding the successes of the last decade, the pace of technological change, coupled with lifestyle changes and rising consumer expectations, means that the industry cannot rest on its laurels and that we need to identify and to proactively address the challenges for the next decade.
9. Ofcom's Initial Conclusions set out its views in light of responses to the July Consultation and included Ofcom's "Key Proposals" moving forward. There is much in those key Ofcom proposals on which BT and Ofcom's views are closely aligned. As Ofcom stated in its Initial Conclusions, it is about ensuring the environment and the investment needed to *"help secure the UK's position as a global leader among our peers in Europe and internationally"* and where *"people and businesses get the phone, broadband and mobile service they need in coming years, wherever they live and work"*.
10. BT agrees with Ofcom that:
 - a. We live in a digital world where connectivity to the world is very important, in a manner akin to utilities services such as water, gas and electricity, and that the communications industry must deliver the networks and services that consumers and businesses will need and expect;
 - b. Broadband, offering at least 10 Mbit/s at affordable prices, should be universally available;
 - c. In recent years, service levels have not kept pace with the rise in consumer or industry expectations, and BT needs to be at the forefront of delivering better quality of service, to share its part of the responsibilities of the whole industry;
 - d. Consumer welfare will be maximised when consumers have real power to exercise choice on an informed basis, using easy switching processes that deliver good customer experience; and
 - e. BT also agrees that, as consumers' demands for increased bandwidth rise, CPs need to ensure that their networks are upgraded to meet that

demand, albeit that it is clear that there are divergent views in the industry as to the best technology options and roll out programmes to deliver those network upgrades.

11. BT is already acting on many of these initiatives.
- BT agrees with Ofcom that all consumers and businesses across the UK need to be able to access a 10 Mbit/s fast broadband service and has offered to provide that level of Universal broadband service;
 - Openreach is committed to delivering better service, and, as explained in Annex B, aims to not only meet and exceed the minimum levels of service set by Ofcom, but continue to improve the overall service delivered to homes as well as businesses; and
 - BT is working closely with Ofcom and the industry to support improvements in customer switching across all fixed and mobile services and supports Ofcom's and the UK's government preference for switching processes that are led by the gaining provider and therefore place the consumer at the heart of the process.

BT's plans in relation to the development of BT's network and the move to Ultrafast broadband services are addressed in section 3.4.2.3 below.

12. In July 2016, Ofcom published its July Consultation. As part of that consultation, Ofcom indicated that its "*preferred model*" was the "*legal separation*" of Openreach from the rest of BT. As described in Section 2.2 below, Ofcom's Preferred Model is intended as an extreme form of functional separation, to be imposed on BT in default of agreement as a mandatory regulatory requirement under EU and UK law.

2.2 Ofcom's Proposals

13. Despite the broad ambit of the DCR at the outset, it is clear that the current consultation exercise has become focused on the single issue of Openreach governance, which is being considered essentially as a standalone issue rather than as one aspect of its wider strategic review. As BT explains at para. 16, et seq. below, the nature and implications of Ofcom's Proposals need to be considered in that wider context.
14. The main features of this arrangement, which we refer to as "**Ofcom's Preferred Model**" in this response, are described by Ofcom as follows:¹⁰
- a. Openreach will be incorporated as a separate company with its own Articles of Association and governance arrangements;
 - b. The Articles of Association for the separate Openreach company will "*make clear that one of the company's purposes is to act in the interests*

¹⁰ Para. 1.24, July Consultation.

of all downstream customers equally, and that the Openreach directors must act accordingly”;

- c. The Openreach Board will have a majority of non-executive directors, including the Chair;
 - d. The Openreach Chief Executive will be appointed by the Openreach Board. There will be no direct lines of reporting from the Openreach executive to BT Group executives of functions, save where specifically and exceptionally agreed with Ofcom;
 - e. Openreach will be obliged to *“consult formally with all downstream customers on large-scale investments”*, including through a *“confidential phase”* where customers can discuss ideas without this being disclosed to BT Group;
 - f. People who work for Openreach will be employees of the separate Openreach Company, rather than employees of the BT Group;
 - g. Openreach will own those assets it already controls, namely the underlying infrastructure associated with its network;
 - h. Openreach will have *“increased resources and capability to support effective governance of Openreach”*;
 - i. Openreach will have *“its own brand, not affiliated with BT Group”*; and
 - j. Regulatory compliance will become a duty of the Openreach Board, removing the need for the current EAB.
15. These features of Ofcom’s Preferred Model are said by Ofcom to fall short of full structural separation of Openreach from BT, although Ofcom states that if the *“preferred model of legal separation cannot be made to work, then full structural separation remains an option”*.¹¹ However, Ofcom itself has recognised the potential that its Preferred Model could result in significant costs and has identified a number of areas where flexibility on its Preferred Model could be available, particularly if the costs associated with implementation are high. These include the possibility not to require BT to transfer to Openreach all assets, people, contracts and systems it currently has access to in order to deliver its services (we refer to this as **“Ofcom’s Alternative Model”** in this Response). The nature and implications of each of Ofcom’s Proposals are discussed in detail in Section 4 below. In particular, notwithstanding Ofcom’s characterisation of its Preferred Model as falling short of full structural separation, it is clear that it envisages BT acting merely as a passive investor in Openreach, in a manner that amounts to virtual structural separation, and prizes Openreach’s independence to the exclusion of BT’s legitimate

¹¹ Para. 1.20, July Consultation.

proprietary rights and the benefits to it and the wider market that derive from vertical integration.

2.3 Wider regulatory context

16. The July Consultation is just one strand of work in Ofcom's Strategic Review of Digital Communications. Likewise, Ofcom's Proposals are only one of several sets of measures that Ofcom is proposing to help achieve its wider strategic regulatory objectives for the UK in the next decade.
17. This is the backdrop against which consideration of the right model of governance for Openreach needs to be considered. However, BT is concerned that Ofcom's starting point in the July Consultation is not the right one, and that it has not properly grappled with these issues, for several reasons:
 - a. Ofcom should consider the best way to deliver the full range of policy objectives that exist, in particular, promotion of competition, the driving of investment and innovation and alignment to end customer needs;
 - b. However, consideration of the right model of governance for Openreach, and in particular the necessity to intervene and mandate any particular model of governance, should be focused on making a clear connection between a well evidenced theory of harm in the market under current arrangements and proposed new governance arrangements, in accordance with the statutory regime at both EU and UK level;
 - c. Given that, as we explain further in Section 2.4 below, functional separation is a regulatory remedy of last resort, consideration of an appropriate model of governance should be undertaken only **after** Ofcom has set the general regulatory framework to address its concerns and objectives, i.e. when it can undertake a proper enquiry as to whether those remedies suffice, rather than at a time when many other regulatory parts are still moving;
 - d. As BT explains in Section 4 below, Ofcom's Proposals would in reality impede the achievement of its wider objectives, in particular the promotion of investment, innovation and alignment with customer needs. Ofcom's Proposals would make it more difficult for BT and Openreach, for example, to roll out fibre networks, including networks that offer 1 Gbit/s speeds or networks for the last 5% of customers who do not yet have fast or superfast broadband; and
 - e. Similarly, Ofcom has not resolved the tension in its policies between promoting competition at two different levels in Openreach, that based on active products, such as GEA (in the fibre broadband market) and EAD (in Ethernet markets), and that based on passive products, such as duct and pole access (in the fibre broadband market) and dark fibre regulation (in Ethernet markets) in supporting investment by new access providers.

18. BT is extremely concerned that since the Initial Conclusions the debate has not had proper regard to the fact that the part that Openreach governance should play in delivering the key objectives of the strategic review is but one aspect of the overall DCR: it has increasingly become a single issue debate about “*how much of Openreach does BT really need to keep hold of*” and “*what is the minimum control that BT can have over Openreach*”, rather than the overarching question of “*what changes (if any) are appropriate and justified to help deliver the wider aims of the DCR notably increased investment and to promote infrastructure competition?*”.
19. Ofcom’s prejudice in this regard was evident in its very first consultation document¹² in July 2015 (the “**Discussion Document**”). As we set out to Ofcom at the time, Ofcom did not set out a balanced or neutral presentation of the issues regarding the regulation of vertically integrated operators, but a one-sided list of about 20 unsupported allegations against BT, none of which was founded in fact.
20. For example, in the July Consultation, rather than adopting a neutral focus, Ofcom introduced its discussion on the promotion of competition by commenting that:
- “The history of fixed telecoms regulation in the UK can be seen as a long-running debate, spanning multiple decades, on how best to address concerns regarding BT’s position in the sector.”*
21. In essence, the sole focus of this consultation exercise is on BT’s organisational structure without regard to any justification for changing the current approach, nor any assessment of BT and Openreach’s ability to compete with a vertically integrated competitor in Virgin Media across half the country, nor any benefits arising for end-customers. Ofcom has not taken an appropriate step back and weighed appropriately the fact that UK fixed communications markets are already exceptionally competitive, and are likely to become ever more competitively supplied, nor the fact that UK fixed communications markets are delivering exceptionally good outcomes for customers; nor has Ofcom properly considered if other measures to encourage investment and innovation in network infrastructure for the benefit of customers would deliver even more positive market outcomes within a foreseeable timeframe.
22. BT also notes that in adopting this approach, Ofcom also appears not to have regard to the conclusions it had itself reached in 2005 in the previous Strategic Review. In particular, in relation to “strategic integration” of BT, Ofcom concluded in its June 2005 Notice under s. 155 EA02 as follows:
- “The proposed undertakings would address this concern by giving ASD a degree of independence within an annual operating plan and capital expenditure plan agreed with the BT group. While this would not completely resolve the tension between the division’s strategy and the broader strategy of the BT group, we consider that **this is as far as it is reasonable and***

¹² “Strategic Review of Digital Communications: Discussion Document”, dated 16 July 2015

practicable for the undertakings to go. The alternative – entirely independent strategic plans for ASD – would not be compatible with the continuing duties of a single board of directors of British Telecommunications plc” (bold emphasis added).¹³

23. In this response, BT will show that Ofcom has failed to justify departure from its earlier regulatory conclusion, and has failed to carry out the detailed factual and economic review that it would be required to do before it could justify resort to such an extreme form of functional separation.
24. Those failings are not just a breach of best regulatory practice but are in direct contravention of Ofcom’s regulatory duties under the ERF and the CA03.
25. BT sets out the applicable legal framework in this Section and then discusses its application in Sections 3, 4 and 5 below.

2.4 Legal Framework

2.4.1 SMP regulation under the ERF

26. The ERF consists of a number of Directives, including the AD, the Framework Directive (“**FD**”)¹⁴, and the Authorisation Directive (“**AuD**”)¹⁵ and establishes a “harmonised framework” for the regulation of electronic communications networks throughout the EU.¹⁶ NRAs such as Ofcom, must coordinate with the European Commission (“**the Commission**”) and the Body of European Regulators for Electronic Communications (“**BEREC**”)¹⁷ in order to ensure that the ERF is applied in a consistent and transparent manner.¹⁸
27. Under the ERF, NRAs are required by Articles 3 and 6 AuD to impose general obligations specified in the Annex thereto and are also permitted to impose a limited category of specific obligations, including obligations on undertakings found to enjoy significant market power (“**SMP**”) on a relevant market: see Article 6(2) AuD and Articles 8-13b AD.
28. AD harmonises the regulation of network access and interconnection within the framework set up by FD and AuD. Articles 9 to 13 AD set out an escalating list of conditions which may be applied by NRAs to undertakings found to have

¹³ “ASD” or Access Services Division was the description used in the Undertakings for the new line of business that is now called Openreach.

¹⁴ Directive 2002/21/ EC, as amended with effect from 19 December 2009, by Directive 2009/140/EC.

¹⁵ Directive 2002/20/EC, as amended with effect from 19 December 2009, by Directive 2009/140/EC.

¹⁶ Article 1(1) FD.

¹⁷ BEREC was established by Regulation (EC) No 1211/2009 of the European Parliament and of the Council of 25 November 2009. The CEO of Ofcom is a member of the Board of BEREC, as are the heads of the NRAs of each of the Member States.

¹⁸ Article 7(1) and (2) FD.

SMP on a relevant market. All SMP regulation under Articles 9-13b AD is subject to Article 8(4) AD, which requires such regulation to be “*based on the problem identified, proportionate and justified in the light of the objectives laid down in Article 8 [FD]*”.

29. The objectives specified in Article 8 FD are also reflected in the domestic obligations imposed on Ofcom under ss. 3, 4 and 6 CA03, and in particular s. 4, which sets out the relevant obligations in order as duties that Ofcom must observe in performing its regulatory functions: see s. 4(2). In particular, Ofcom’s primary duty is to further the interests of citizens and those of consumers, in respect of choice, price, quality of service and value for money. Where appropriate, it must do so by promoting competition (s.3(1)). In performing those duties, Ofcom must check that its regulatory activities are transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and represent the best regulatory practice (s.3(4)).
30. Article 13a AD, which was added by amendment by the Better Regulation Directive 99/140/EC (“**BRD**”),¹⁹ as implemented in the United Kingdom by ss. 89A and B CA03 with effect from 26 May 2011, confers an additional and exceptional power on national regulatory authorities to impose “Functional Separation” of the wholesale access business. Article 13b AD, implemented at the same time by s.89C CA03, sets out the process which NRAs must follow if an undertaking with SMP notifies **voluntary functional or structural** separation of its wholesale access business.
31. Articles 13a and 13b are discussed in more detail below, including the BEREC Guidance on functional separation under Articles 13a and 13b of the revised AD and national experiences” (“**the BEREC Guidance**”).
32. Ss. 89A and 89B give effect to Article 13a, and s.89C to Article 13b. As such, they must be interpreted and applied in a consistent manner, with the wording of the Articles being the final authority, binding on Ofcom as the UK NRA. For ease of reference, BT will in this response only refer to Articles 13a and 13b as shorthand for both the EU and domestic framework.

2.4.2 Article 13a²⁰

33. The power to impose “Functional Separation” under Article 13a is the most intrusive form of SMP regulation permitted by the ERF. Functional separation in this context means that the wholesale access business of a vertically

¹⁹ Directive 2009/140/EC of the European Parliament and of the Council of 25 November 2009. The BRD introduced the new Article 13a AD.

²⁰ BT notes that pursuant to Article 8(3) of the Access Directive that “in exceptional circumstances” NRAs may impose measures on operators beyond the SMP obligations set out Articles 9 to 13 of the Directive. However, this provision cannot be taken to bypass the express scheme governing the imposition of functional separation pursuant to Article 13a of the Access Directive: it is clear that under the Directive, any mandated functional separation remedy must comply with the strict requirements of Article 13a.

integrated company is carried on by a separate business entity belonging to the same parent company.²¹

34. The purpose of functional separation under Article 13a is to **ensure that products and services are supplied in a non-discriminatory manner**, i.e. “on the same timescales, terms and conditions, including those relating to price and service levels, and by means of the same systems and processes”. This intent is also reflected in recital 61 to the BRD, which states that the purpose of functional separation is “to ensure the provision of fully equivalent access products to all downstream operators ... significantly reducing the incentive for discrimination and by making it easier to verify and enforce compliance with non-discrimination obligations”. The BEREC Guidance further confirms this interpretation, noting that the purpose of functional separation is to ensure the provision of wholesale access products to all downstream operators, including the operator’s own vertically integrated downstream divisions i.e. to ensure “full *Equivalence of Access*”.²²
35. The use of Article 13a is an exceptional measure that is subject to strict substantive and procedural conditions in view of the intrusive nature of the remedy.
36. **First**, a functional separation obligation may only be imposed where the NRA can demonstrate that any standard SMP conditions imposed under Article 9 to 13 AD “*have failed to achieve effective competition*”: see Article 13a(1), first sentence. This means that Article 13a is a remedy of last resort. Ofcom does not observe this requirement.
37. The BEREC Guidance confirms this interpretation and notes that, as a result, it will not be sufficient for an NRA to rely on the “*mere formal imposition*” of the SMP conditions in Article 9 to 13 AD to justify a conclusion that functional separation is the sole remedy that can help alleviate competitive problems detected in the marketplace. Instead, the NRA must:
 - a. allow a reasonable amount of time to pass before the imposition of other SMP conditions and the conclusion that functional separation is necessary; and
 - b. consider whether those SMP conditions “*have been properly designed and ... consistently applied*”. For example, if there is a substantial track record of enforcement activity against the SMP operator “*regarding instances of discrimination*”, this may assist the NRA in concluding that functional separation is an appropriate option.²³
38. **Second**, Ofcom must be able to demonstrate that there are “*important and persisting competition problems and/or market failures*” in relation to the

²¹ See, for example, s. 18A(2) CA03 (as amended).

²² The BEREC Guidance also cites Recital 61 BRD.

²³ BEREC Guidance, section 2.1.2, page 10.

wholesale provision of certain access product markets. Ofcom has not demonstrated this, because it is not the case. As the BEREC Guidance makes clear, this means that, in addition to concluding that the imposition of standard remedies has been ineffective to solve the competition problems in the access markets, it must also demonstrate those problems are *important* and *persistent*.²⁴

39. Reflecting the purpose of Article 13a, the question for the NRA will be whether despite the efforts of *ex ante* regulation, competition is not effective “due essentially to **significant and persistent discriminatory practices** by the SMP operator” (emphasis added).²⁵ Relevant evidential indicators will include:
- market shares and trends over time;
 - increase in disputes between the incumbent and other CPs regarding discriminatory practices;
 - persistent problems of discrimination; and
 - the retail market structure i.e. whether other CPs are prevented “*from offering viable services in terms of price packaging, quality of service, or commercial and technical features (e.g. does the retail market see alternative offers based on LLU?)*”.²⁶
40. **Third** and relatedly, the imposition of Article 13a is an “*exceptional measure*”.²⁷ Ofcom must be able to show that functional separation is justified by exceptional circumstances (including that other SMP obligations are found to have failed). Ofcom has not shown this, because there are no such circumstances. BEREC confirms this interpretation, noting that functional separation is “*a costly, complex and intrusive measure*” as reflected in the specific non-standard procedural requirements that NRAs must satisfy and “*in the burden of proof that needs to be fulfilled when justifying the necessity of the measure*” (emphasis added).²⁸
41. **Fourth**, the exceptionality of the measure is confirmed by the fact that it is subject to the procedural requirements of Article 8(3), which provides for a specific procedure to be followed by an NRA before it can impose an SMP obligation other than those set out in Articles 9 to 13. In accordance with this procedure, Ofcom must submit to the Commission on any proposal for functional separation and, in turn, the Commission must take utmost account of the opinion of BEREC; and the Commission is to decide to authorise or to

²⁴ BEREC Guidance, section 2.1.4, page 13.

²⁵ *Ibid.*, section 2.1.4, page 13.

²⁶ *Ibid.*, section 2.1.4, page 14.

²⁷ Article 13a(1) AD, first sentence.

²⁸ BEREC Guidance, section 2.1.2, page 8.

prevent an NRA from imposing functional separation as a remedy. When Ofcom submits its proposal to the Commission it must do all of the following:²⁹

- a. provide evidence which demonstrates that the SMP conditions under Articles 9 to 13 FD have failed to achieve effective competition, and that there are important and persisting competition and/or market failures in the wholesale access market;
 - b. provide reasons why it considers that there is *“little or no prospect of effective and sustainable infrastructure-based competition within a reasonable time frame”*;
 - c. carry out an impact assessment i.e. an analysis of the expected impact of functional separation on a range of matters including the impact on BT (in particular BT’s workforce); on *“the electronic communications sector as a whole”*; and on the *“expected impact on competition and any other potential consequential effects on consumers”*; and
 - d. provide reasons justifying the conclusion that functional separation is *“the **most efficient means** to enforce remedies aimed at addressing the problems or market failures identified”* (bold emphasis added).
42. **Fifth**, as noted in point 41.c above, Ofcom must carry out an impact assessment, which it has not done. The BEREC Guidance emphasises the importance of this assessment *“according to the necessary analysis of proportionality, following the principles listed in Article 8 of the Framework Directive ... to justify the implementation of functional separation in the national markets”*.³⁰ BEREC also notes the difficulty of this assessment, cautioning that *“a quantitative assessment of both benefits and costs is likely to be very challenging”*³¹ and the impact analysis *“could become the most difficult aspect of the whole analysis”*.³²
43. In order to assist NRAs, the BEREC Guidance sets out some relevant considerations for the purpose of the impact assessment, including:
- a. in relation to the NRA, disadvantages of functional separation may include a significant increase in workload, while potential advantages include the potential to *“ease the regulatory burden, as discriminatory practices by the vertical-integrated operator should not engage the*

²⁹ Article 13(a)(2) AD.

³⁰ Ibid. at [24], section 2.1.2, page 8. The BEREC Guidance notes in this connection that the proportionality criteria to be applied are the same as those set out in the *Fedesa* case, which are described below.

³¹ Ibid., section 2.1.4, page 13.

³² Ibid., section 2.1.4, page 15.

regulator to the same degree and the number of inter-operator disputes should show a decrease”,³³

- b. in relation to the undertaking itself, disadvantages will include that the imposition of functional separation “*would have a significant impact ... as it will necessarily be obliged to change the way it functions*” and it “*may incur high costs to implement separation*”,³⁴ and
 - c. critically, NRAs are obliged to consider whether incentives to invest, including in particular NGA investments, might be reduced by functional separation. The BEREC Guidance notes that incentives to invest in new networks by the incumbent “*could be deterred if it anticipates that the new assets could be transferred to the separate entity*”.³⁵ This is consistent with Recital 61 BRD, which states that it is important to ensure that the imposition of functional separation “*preserves the incentives of the concerned undertaking to invest in its network and it **does not entail any potential negative effects on consumer welfare***” (bold emphasis added). It is, therefore, a matter of regulatory best practice and a legislative expectation that Ofcom will carefully examine the potential implications that the imposition of a functional separation remedy may have on incentives to invest.
44. BT has had no opportunity to comment on Ofcom’s case which will have to be evidenced and reasoned to the necessary standards, in any application to the Commission. BT puts a marker down that it expects to have an opportunity to do so simply as a matter of ordinary due process and rights of defence if, in due course if Ofcom is, despite the weight of evidence to the contrary, minded to proceed with its proposals under Article 13a.
45. In addition to these strict substantive and procedural conditions, which are expressly stated in Article 13a, and which Ofcom has not observed, the broader statutory context makes clear that the power to require functional separation must only be exercised where no less restrictive alternative remedy exists:
- a. Article 8(4) AD expressly provides that all SMP obligations imposed pursuant to Articles 9 to 13a must be “*based on the nature of the problem identified, **proportionate and justified***” (bold emphasis added) in the light of the objectives in Article 8 FD. It follows that Ofcom may only impose functional separation if it can demonstrate that this is (exceptionally) necessary to achieve one of the objectives set out in Article 8 FD;
 - b. Article 1(3) FD contains express provision that any measures regarding access to or use of services and networks shall respect the European Convention on Human Rights (“**ECHR**”) and EU fundamental rights.

³³ Ibid., section 2.1.4, page 15.

³⁴ Ibid., section 2.1.4, page 15-16.

³⁵ Ibid., section 2.1.4, page 16.

These include an operator's own right to own and operate its existing business under Article 1 Protocol 1 ECHR and Article 17 of the EU Charter of fundamental rights. Functional separation can therefore only be imposed by Ofcom if it is "*appropriate, **proportionate** and necessary within a democratic society*" (bold emphasis added) and adequately protected by procedural safeguards;

- c. Article 8 FD states that NRAs must apply "*objective, transparent, non-discriminatory and **proportionate** principles*" (bold emphasis added). It continues, expanding on these requirements, that NRAs may impose "*ex ante obligations only where there is no effective and sustainable competition and relax or lift such obligations as soon as that condition is fulfilled*" (emphasis added);³⁶
- d. Recitals 25 and 27 to the FD make clear that ex ante obligations may only be imposed where there is not effective competition, and where national and Community competition law remedies are not sufficient to address the problem;
- e. Recital 14 to the AD likewise makes it clear that the specific SMP remedies in Articles 9-13 AD were intended to be "*a set of maximum obligations that can be applied to undertakings, in order to avoid over-regulation*"; with that general approach now subject only to the limited exceptions provided for in Article 13a introduced by the BRD subject to the conditions set out above; and
- f. Finally, in accordance with recital 62 BRD, functional separation is now permitted subject to the exceptional safeguards set out above – such a measure should, in particular, "*not prevent appropriate coordination mechanisms between the different separate business entities **in order to ensure that the economic and management supervision rights of the parent company are protected***" (bold emphasis added).

2.4.3 Article 13b

- 46. Article 13b AD, which is headed "***Voluntary** separation by a vertically integrated undertaking*" (bold emphasis added), requires an undertaking which has been designated as having SMP in a relevant market to inform the NRA if it intends its "*local access network assets or a substantial part **thereof to a separate legal entity under different ownership, or to establish a separate business entity***" (bold emphasis added) to provide wholesale access products. The NRA must then assess the effect of the intended transaction, carrying out a market review and deciding what modified or additional SMP obligations (if any) to impose on the new separate "*legal*" or "*business*" entity.
- 47. There are two important points to note about Article 13b. First, it is plainly not intended to be a source of mandatory obligations on undertakings such as BT, save in respect of the requirement of notification. The provisions only apply in

³⁶ Art 8(5)(f) FD.

relation to **voluntary** restructuring by an undertaking with SMP. Rather, Article 13b simply imposes obligations on an NRA such as Ofcom to, “*assess the effects of the intended transaction on existing regulatory obligations under [the Framework Directive]*”, to ensure that the SMP regime continues to operate effectively where it is notified by an undertaking with SMP of its intention to restructure its business (the “*intended transaction*”).

48. **Second**, unlike Article 13a or any other provision of the ERF, Article 13b AD expressly envisages the possibility of (voluntary) structural separation (i.e. an undertaking with SMP deciding to transfer assets to a separate legal entity under different ownership) in addition to functional separation (i.e. establishing a separate business entity). This is in clear contrast to Article 13a AD, which is concerned only with functional separation. The focus on functional separation is evidenced not only from the title of Article 13a, but also because it envisages that an undertaking with SMP may be required to use an “*independently operating business entity*” within the same parent company.³⁷
49. Thus, while an undertaking with SMP may of course itself decide to restructure its business in a way that involves structural separation under Article 13b AD (so requiring the NRA to carry out a market analysis and consider what obligations, if any, to impose on the new corporate structure), an NRA clearly has no power to impose structural separation as an SMP obligation, whether under Article 13a or Article 13b³⁸ or any other provision of the ERF.
50. On 18 July 2016, BT made the BT Proposal, a voluntary notification to Ofcom setting out the BT Proposal, pursuant to Article 13b AD. However, BT observes that Ofcom has yet to commence the market analysis enjoined by Article 13b.

2.4.4 Proportionality principle

51. As a matter of EU law, specifically incorporated into UK law by ss. 3, 4 and 47(2)(c) CA 2003 (and see also ss. 87-89C, and in particular s. 89B(2) CA 2003 in respect of functional separation), the proportionality principle requires that:
- a. a measure is appropriate and necessary in order to achieve the legitimate objective which it pursues;
 - b. when there is a choice between several appropriate measures, recourse is had to the least onerous measure; and

³⁷ See also s. 89A of CA03 (as amended).

³⁸ We note in this regard that the characterisation of a separation remedy as functional or structural is a matter of substance, having regard to the degree of separation that is in fact imposed. The mere labelling of a measure as “functional separation” by Ofcom does not mean that the measure necessarily constitutes a functional separation measure for the purpose of Article 13a, which requires the substantive and procedural conditions of Article 13a to be satisfied.

- c. the disadvantages caused by the measure are not disproportionate to its aims.³⁹
52. Moreover, as a matter of regulatory best practice, Ofcom has recognised – and BT is entitled legitimately to expect – that its regulatory interventions must be “*evidence-based, **proportionate**, consistent, accountable and transparent in both deliberation and outcome*”⁴⁰ (emphasis added), and that it will seek “*the least intrusive regulatory mechanisms to achieve its policy objectives*”.⁴¹
53. The intensity with which the proportionality principle is applied by domestic courts will vary from case to case.⁴² Where a national measure derogates from rights protected by the Treaties, including the right to property, the court must determine whether the measure is suitable to achieve the legitimate aim in question and, if there is a choice of equally effective measures, whether it is on more onerous than is required to achieve that aim.⁴³ The justification will be “*examined in detail*”,⁴⁴ and the court will also “*examine closely*” whether other measures could have been equally effective but less restrictive of the freedom in question.⁴⁵
54. In relation to the “*less restrictive alternative*” test, the court must have regard to “*all the circumstances bearing on the question*”, including “*the circumstances which led to the adoption of the measure in question, and the reasons why less restrictive alternatives were rejected*”.⁴⁶ Although the decision-maker will have some margin of appreciation, a measure will not be proportionate, “*if it is clear that the desired level of protection could be attained equally well by **measures which were less restrictive***” (bold emphasis added).⁴⁷

2.4.5 Technological neutrality

55. BT also observes that, as a matter of regulatory best practice, Ofcom should respect the principle of technological neutrality. As the Shortall Review submitted with this Response notes,⁴⁸ the ERF embodies technological neutrality, an underlying element of which is that the choice regarding technology, is best left to those organisations which are likely to have the best

³⁹ See Case C-331/88 *R v Minister for Agriculture, Fisheries and Food, Ex p Fedesa* [1990] ECR I-402.

⁴⁰ S. 3(3) CA03. Ofcom is also referred to s6 CA03 which establishes a duty on Ofcom not to impose burdens that are unnecessary.

⁴¹ Ofcom Regulatory Principles.

⁴² *R (Lumsden) v Legal Services Board* [2015] UKSC 41 at [34].

⁴³ *Ibid.* at [55]

⁴⁴ *Ibid.* at [56]

⁴⁵ *Ibid.* at [61]

⁴⁶ *Ibid.* at [67].

⁴⁷ *Ibid.* at [66].

⁴⁸ See Section 3, para. 5(c), below.

information about it at their disposal, and which have the strongest incentive to make the right choice, i.e. firms in the marketplace, such as BT, and their investors.⁴⁹

56. Contrary to this underlying principle, the Ofcom Proposal is premised on a choice by the regulator, and not the market, in favour of a particular technology (FTTP). BT elaborates in Section 3 below that Ofcom’s reasoning in this regard is fundamentally flawed.

2.4.6 Enterprise Act undertakings

57. Under s. 154 EA02, instead of making a market investigation reference to the CMA⁵⁰, Ofcom may accept appropriate undertakings for the purpose of remedying, mitigating or preventing any adverse effect on competition (or on consumers) about which it has concerns. The Undertakings were accepted by Ofcom pursuant to s. 154(2).
58. The effect of such undertakings is that, provided that the undertaking is not breached, Ofcom is precluded from making a reference to the CMA for a period of 12 months in respect of the relevant features of the market to which the undertaking relates: s. 156(A1) and (1) EA02. More generally, where such an undertaking is in force, Ofcom is subject to two statutory duties:
- a. To keep such undertakings under review pursuant to s. 162(1), and in particular “*from time to time consider ... whether, by reason of any change of circumstances, an enforcement undertaking is no longer appropriate and ... needs to be varied or to be superseded by a new enforcement undertaking*”: s. 162(2)(b)(ii),⁵¹ and
 - b. To consider “*as soon as reasonably practicable, any representations received by it in relation to varying or releasing an undertaking under this section*”: s. 154(7).
59. It is a further significant defect of the July Consultation that, although paras. 7.3 and 9.10 do refer to the fact that BT has made an application to vary the Undertakings pursuant to EA02, Ofcom appears to have given little or no thought to that application (however, we note that, in para. 7.48, Ofcom provisionally dismisses BT’s Proposal). In particular, Ofcom provides no details as to how it intends to discharge the above statutory duties under EA02,

⁴⁹ Page 22, Shortall Review.

⁵⁰ The CMA and Ofcom enjoy concurrent powers in relation to competition regulation (see Competition Act 1998 (Concurrency) Regulations 2014 and the Memorandum of understanding between the Competition and Markets Authority and Ofcom on concurrent competition powers (2 February 2016). However, the CMA’s powers do not extend beyond the powers granted to Ofcom to regulate BT under the CA 2003 and relevant competition legislation.

⁵¹ Para. 2.26 of OFT 511, referred to at para. 62 below, provides that Ofcom will “*consider any representations received from interested parties that undertakings should be varied or their signatories released from them. **In the absence of such representations reviews will be conducted at five yearly intervals***” (bold emphasis added).

whether it considers the Undertakings to be “*no longer appropriate*”, whether they need to be “*varied or superseded by a new enforcement undertaking*”, or how it intends to respond to BT’s Proposal for a variation to the existing Undertakings.

60. Ofcom appears to take the view that its powers under the EA02 have been in some way superseded by the entry into force of s. 89C CA03. However, it has given no reasons for that view, and appropriate use by Ofcom of its EA02 powers (including the acceptance of undertakings in lieu in a way that does not run counter to the ERF) is clearly not prohibited by the ERF.⁵²
61. Indeed, the BEREC Guidance expressly cites the Undertakings as an example where an undertaking has already implemented functional separation voluntarily, i.e. as a domestic precursor to the procedure now provided for by Article 13b AD. Noting that the purpose of functional separation is to ensure equivalence of access, the BEREC Guidance states that BT has implemented EoI and that this has been “*a key element in ensuring competitors could access products in a fair and non-discriminatory manner*”.⁵³ BEREC notes that (as at February 2011) the Undertakings “*have delivered well in terms of competition and consumer welfare*”.⁵⁴
62. When deciding whether to accept undertakings in lieu of a reference, Ofcom must have regard to the need to achieve “*as comprehensive a solution as is reasonable and practicable to the adverse effect on competition concerned and any detrimental effects on customers*”: s. 154(2) EA02. It continues to be within Ofcom’s powers to achieve a comprehensive solution under the Enterprise Act, as it did in 2005 and as BT has proposed again in 2016.

2.4.7 Guidance on the acceptance of undertakings in lieu

63. The factors relevant to the exercise of discretion by the CMA or sectoral regulators such as Ofcom in deciding whether to make a reference are set out in the Guidance *about the making of references under Part 4 of the Enterprise Act 2002*, OFT 511, paras. 2.1 and 2.20-2.26.
64. In particular, para. 2.1 of OFT 511 provides as follows:

*“The OFT will only make references to the CC **when the reference test set out in section 131 of the Act** and, in its view, each of the following criteria have been met:*

⁵² BT finds Ofcom’s view in relation to its ability to use its 2002 Act powers surprising as such an approach would appear to contrast with the position taken by Ofcom in relation to the wholesale broadcasting transmission market, where Ofcom appears to have decided to forego using its CA03 powers to regulate the market relying instead on the Enterprise Act merger undertakings in lieu given in the Arqiva merger.

⁵³ BEREC Guidance, Annex 1, page 7

⁵⁴ *Ibid.*, page 8. BEREC also notes that there have been challenges as a result of the Undertakings, some of which have been resolved through the years.

- *it would not be more appropriate to deal with the competition issues identified by applying CA98 or **using other powers available to the OFT or, where appropriate, to sectoral regulators**;*
 - *it would not be more appropriate to address the problem identified by means of **undertakings in lieu of a reference**;*
 - *the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it; and*
 - ***there is a reasonable chance that appropriate remedies will be available***".
65. Discharge by Ofcom of its statutory duties in respect of the Undertakings therefore involves at least the following issues:
- a. Whether the concerns that it has identified constitute market features falling within the scope of s.131 EA02;
 - b. Whether those concerns can be addressed using Ofcom's sectoral powers, i.e. its powers under the ERF and CA03;
 - c. Whether they can be addressed by a variation or superseding of the Undertakings; and
 - d. Whether there is a reasonable chance that "*appropriate remedies*" would be available if the matter were referred to the CMA.
66. Ofcom will also need to consider the various factors set out at paras. 2.20-2.26 of OFT 511.

2.4.8 CMA Guidelines on Government Intervention in Markets

67. The CMA has issued guidance to policymakers and regulators on competition impact assessments ("**the CMA Impact Assessment Guidance**"),⁵⁵ noting that government interventions in markets can restrict competition and that "*removing unnecessarily restrictive regulations can ensure government supports competition, productivity and economic growth*".⁵⁶ We consider this guidance to be instructive in respect of the exercise that Ofcom should undertake in exercising analogous powers. The CMA notes, in particular, that measures that limit an entity's choice of "*organisational form*" can restrict its ability to compete, as can measures which impede its incentive to innovate or which affect the price at which services can be supplied.⁵⁷

⁵⁵ Competition Impact Assessment, 15 September 2015 ("CMA 50").

⁵⁶ CMA50, Part 1, §1.7.

⁵⁷ CMA50, Part 2 §§4.2 and 4.23.

68. The CMA Impact Assessment Guidance requires that in depth assessment of the benefits and costs of a proposed intervention must be carried out by reference to a “baseline” or “*counterfactual*” which may be the status quo or an alternative form of intervention.⁵⁸ It explains that, as part of the impact analysis, it is important to consider alternative less restrictive measures. It notes that where a proposal is likely to adversely distort competition, “*policymakers should consider whether there are **alternative proposals** that will achieve the policy objectives but **with less adverse effects**” (bold emphasis added).⁵⁹ Alternative measures should be checked against the original proposal.⁶⁰ Clearly, Ofcom must select the correct counterfactual – which BT considers it has failed to do in the present Consultation.*
69. The impact assessment must assess and measure the impact of the proposed intervention on competition, using a methodology based on both qualitative and quantitative assessments.⁶¹ The purpose of the assessment is to ensure that a reasoned judgment is reached about the preferred option for regulatory intervention, supported by facts, economic arguments and data about the relative cost-benefits of the proposal compared to the alternatives. For particularly significant or controversial issues, quantitative analysis is “*always preferred, where possible*”⁶². As discussed in Section 3 below, BT considers that Ofcom has failed to adduce quantitative evidence to support the remedy it now seeks to impose – a failure that is made all the more striking given the high evidential threshold established by Article 13 AD. BT is further concerned by Ofcom’s reliance on essentially qualitative measures to assess the potential success of its preferred intervention, as discussed in Section 6 of this response.

2.5 BT’s Proposal

70. Since November 2015, BT has put to Ofcom a series of proposals to strengthen and enhance the existing functional separation of Openreach from the rest of the BT Group. The latest version, the BT Proposal, was submitted to Ofcom in draft form on 17 June 2016 and in final form on 18 July 2016. The BT Proposal comprises a formal notification to Ofcom under Article 13b as implemented by s. 89C CA03 of the steps that it will be taking to enhance the functional separation of Ofcom and implement a new model of governance, together with a request under s. 154 EA02 to vary and update the Undertakings.
71. The BT Proposal contains measures which comprehensively address the issues raised by Ofcom and third parties in relation to Openreach’s governance and independence in the DCR in a proportionate manner.⁶³ In particular:

⁵⁸ CMA50, Part 2, §§2.10 to 2.13.

⁵⁹ CMA50, Part 1, §2.10.

⁶⁰ CMA50, Part 8, §§7.1 to 7.3.

⁶¹ CMA50, Part 8, §§8.1 to 8.3.

⁶² CMA50, Part 8, §8.3.

⁶³ As noted in BT’s formal notification of its proposal to Ofcom under s. 89C CA03 (as amended) and s. 154 of the EA02, the fact that BT has made its own proposal in response

- a. BT will establish an Openreach Board as a committee of the BT plc board with delegated authority for the strategy and operational performance of Openreach. The Openreach Board will operate in accordance with a new Governance Protocol, which will provide significantly more independent oversight compared to the current arrangement;
 - b. The majority of the seven members of the Openreach Board will be independent, including the Chair;
 - c. BT plc's Articles of Association will be amended to provide for the delegation of powers to the Openreach Board and to set out the obligation of Openreach to treat all its customers equally;
 - d. Under the Governance Protocol, the supervisory controls retained by BT Group and BT plc will be limited to those matters necessary to ensure ongoing compliance with their corporate and listing responsibilities;
 - e. Openreach will have a significantly enhanced discretion to devise its strategy and to manage and control its day-to-day activities and operational decisions within the scope of the framework set out in the Governance Protocol; and
 - f. An enhanced formal process will be introduced for consultation by Openreach with all CPs on large scale investments. The new process will include a confidential phase within which Openreach will not disclose information outside of Openreach, except to the BT Group CEO and BT Group CFO in defined circumstances as set out in the Governance Protocol.
72. The notification was accompanied by an application to vary the Undertakings to reflect the BT Proposal and also to update the Undertakings to reflect new market circumstances and remove obsolete provisions. BT provided detailed documents to support the BT Proposal, including a draft revised set of undertakings and the proposed Governance Protocol.
73. BT is currently introducing the various elements of this new governance regime, so far as it can, and it is envisaged that (save to the extent that the current Undertakings prevent it from doing so – for example, replacing the EAB with the Openreach Compliance Committee) the BT Proposal will be implemented by January 2017.
74. As noted above, Ofcom is under statutory duties to consider these proposals both as part of its general obligations pursuant to s. 162 EA02 (and the statement of administrative practice in OFT 511) and specifically pursuant to

to the DCR does not mean that BT accepts that there are persistent competition problems in the relevant markets, or that Ofcom has presented evidence to that effect.

s.154(7). The cursory reference to BT's application under EA02 in Ofcom's July consultation is clearly not sufficient to discharge those duties.

2.6 The Merits of the BT Proposal

75. In formulating its Proposal, BT has adopted a principled approach that balances the competing interests of CPs, consumers and shareholders/bond holders/investors, pension holders and Ofcom as regulator. Recognising the good outcomes to date, but that there are new challenges to be met, BT has sought to consider how it can best evolve the Openreach operating and governance model to fit the new world order, so as to give Ofcom everything it needs within the constraints of other legal obligations on BT (as a listed public company and as a single Group of companies) and of proportionality (avoiding unnecessary costs, particularly to the BT Pension Scheme).
76. In developing this new model, BT has listened carefully to the concerns of industry, of consumers and of Ofcom. It has leant in as far as it possibly can to address the concerns raised by others and to accommodate their requests, whilst at the same time having regard to the fiduciary duties of its Board to represent the interests of its shareholders and to ensure that its economic and management supervision rights are respected.
77. BT's new governance arrangements meet all bar the most extreme of Ofcom's proposals, but without incurring the massive cost and disruption that implementation of Ofcom's model of governance would require. And, it can be, and is being, implemented now without the delays, approvals and uncertainty that Ofcom's Preferred Model would entail.
78. As such, BT is doing all that it can to implement its new model of Openreach governance model within the confines of the current regulatory framework and the Undertakings. All that stands in the way of full implementation is Ofcom's agreement to the new model and acceptance of the variation or replacement of the Undertakings in accordance with ss 154 and 155 EA02.⁶⁴ Assuming that is forthcoming, the restructuring could be implemented by January 2017. BT is on track to deliver the changes in governance it is able to implement without Ofcom's agreement by then, as notified.
79. In summary, BT's Proposal constitutes a suitable, realistic and comprehensive alternative to Ofcom's Proposals which should form the counterfactual for assessing the comparative benefits and disadvantages of Ofcom's Proposals to inform the proportionality analysis required under both EU and UK law. If Ofcom wishes to proceed under Article 13a, it must do so based on a proper impact assessment and proportionality analysis relative to the status quo and relative to the new proposals that BT has offered and is, in so far as it can, implementing.

⁶⁴ S. 155 sets out a procedure to be followed where Ofcom is minded to accept an undertaking or material variation to an existing undertaking by publication of a notice and consideration of representations made in relation to such notice.

80. In considering these issues, and in particular whether it has demonstrated a need for further functional separation justifying the exercise of its exceptional powers under Article 13a AD/ss. 89A and 89B CA03, Ofcom must take full account of the objectives set out in Article 8 FD and s.4 CA03, including, in particular, its duty to promote competition, efficient investment, innovation, infrastructure competition (particularly enhancing duct and pole access, dark fibre and effective implementation of the Civil Infrastructure Directive) with a view to furthering consumers' interests.
81. In the following sections, BT will demonstrate that:
- a. Ofcom has singularly failed to demonstrate that there is any sufficient justification for additional mandatory regulation pursuant to Article 13a AD or ss. 89A and 89B CA03: **Section 3**;
 - b. Ofcom's Proposals (even with suggested mitigations) cannot be said to be the most efficient or least restrictive means of addressing Ofcom's concerns - contrary to the principle of proportionality and the wider objectives to be taken into account by Ofcom, Ofcom's Proposals risk causing BT and the industry considerable uncertainty and delay, worse market outcomes, reduced investment and significant costs that in the end will flow through to competitors and consumers causing welfare loss for the sector as a whole: **Section 4**;
 - c. BT's Proposal is fully sufficient to address Ofcom's and other interested parties' legitimate concerns in respect to the governance of Openreach, indeed goes well beyond what is necessary to provide appropriate reassurance: **Section 5**; and
 - d. Ofcom's proposed measures of success are not appropriate or well founded in the evidence or as a matter of economic principle: **Section 6**.

SECTION 3 - OFCOM'S DEFICIENT THEORY OF HARM

3.1 Introduction

1. In Section 2 above, BT explained that Ofcom would need a powerful evidential case, showing that standard SMP remedies were insufficient, to justify adopting the remedy of last resort to impose mandatory obligations on BT on the basis of 'exceptional circumstances' shown to exist in the UK market.
2. In this Section, BT assesses the evidential basis for the theory of alleged harm advanced by Ofcom in justifying its preferred model of extreme functional separation.
3. Ofcom makes 3 central allegations against BT, namely that:
 - a. The combination of BT's upstream market power and vertically-integrated structure means that BT still has an incentive to discriminate against competing providers in favour of its own retail business (referred to herein as "strategic discrimination"). Ofcom alleges that BT can (and unless constrained by its new model of governance, could in future) act on this incentive through the way strategic and operational decisions are made about new investments by Openreach, despite the application of its existing SMP regulations and the constraints of the Undertakings. More specifically, Ofcom has identified a risk that there are network investments which are in the interests of consumer and businesses "as a whole" (and profitable for Openreach) but which would not be undertaken under the current governance arrangements because the investment would benefit BT's retail rivals more than BT Consumer;
 - b. BT has previously made certain key strategic investment decisions without consulting Openreach's customers; and
 - c. Ofcom cites general areas of concern relating to BT's performance on quality of service and the level of investment in UK infrastructure in general, especially in the rollout of FTTP.
4. BT does not accept that Ofcom can justify its Proposals because:
 - a. Ofcom's concerns are wrong and unfounded and entirely unsupported by evidence or economic analysis;
 - b. Far from being a beneficial regulatory intervention, Ofcom's proposals are harmful to the sector with detrimental effects for investment, competition and consumers; and
 - c. Ofcom's proposed intervention comprehensively fails to meet the strict legal and evidential requirements in Article 13a/s.89A and B which must be met to justify the imposition of such an extreme functional separation as an exceptional SMP remedy.

5. In support of its response on these issues, BT refers to:
- a. An expert report prepared by Analysys Mason, which is annexed to this Response (the “**Analysys Mason 2016 report**”), demonstrating that there are no competition problems in the UK justifying the extreme intervention proposed, either in relation to wholesale access products or at the infrastructure level;
 - b. An expert report, prepared by Compass Lexecon, and headed “*An economic analysis of Ofcom’s concerns and proposals*”, which is annexed to this Response (the “**Compass Lexecon Main Report**”). Compass Lexecon concludes that Ofcom’s concerns are not economically robust as Ofcom’s assessment is based on mere assumptions or theoretical possibilities rather than direct evidence or robust analysis.”⁶⁵
 - c. An expert report from Tony Shortall, previously an economist at the EU Commission DG Information Society, headed “*Review of Ofcom’s proposals to impose deeper Separation Remedies on BT*”, annexed to this response (the “**Shortall Review**”). He concludes that Ofcom’s Proposals would amount to a misuse of Article 13a; and
 - d. A report by EY headed “*BT’s Regulatory Profitability*” is annexed to this Response (the “**EY Regulatory Profitability Report**”), which addresses allegations that BT’s profitability has been consistently above its cost of capital and which sets out the facts about returns where BT has been subject to regulation.
6. This Section is structured as follows, reflecting the statutory structure of Article 13a and ss. 89A and B:
- i. Introduction
 - ii. Market outcomes in the UK are exceptionally positive
 - The UK is outperforming on international benchmarks
 - Competition in relation to wholesale access is exceptionally strong
 - Infrastructure-based competition is already strong and growing
 - i. The existing regulatory regime has been successful
 - ii. There are no persisting competition problems in relation to wholesale access
 - iii. Ofcom’s theory of harm is wrong and unfounded

⁶⁵ Para. 4.5, Compass Lexecon Main Report.

- iv. There is no element of exceptionality to justify Ofcom's Proposals
- v. Conclusion

3.2 Market outcomes in the UK are exceptionally positive

- 7. Contrary to Ofcom's theory of harm, there is no evidence that there are persistent competition problems or that consumers in the UK are suffering poor market outcomes. If anything, the conditions of competition in the UK market are exceptionally dynamic. Market outcomes from fixed communications services in the UK for all consumers (business and residential) are exceptionally positive in terms of availability of high speed networks, their take-up, prices and the consequent vibrancy of the communications-based internet economy. The UK exhibits a strong performance both in its own right and when assessed against its peers.

3.2.1 BT is outperforming on international benchmarks

- 8. Ofcom's Initial Conclusions acknowledged that the UK has performed strongly against international benchmarks in delivering superfast broadband connectivity to UK consumers.⁶⁶
- 9. The European Commission's Digital Economy and Society Index⁶⁷ ranks the UK:
 - **sixth** out of 28 EU countries on the overall DESI assessment; and
 - **first** amongst the EU-5 on all the main metrics for broadband connectivity, coverage, take-up, speed and price.⁶⁸

3.2.1.1 Coverage

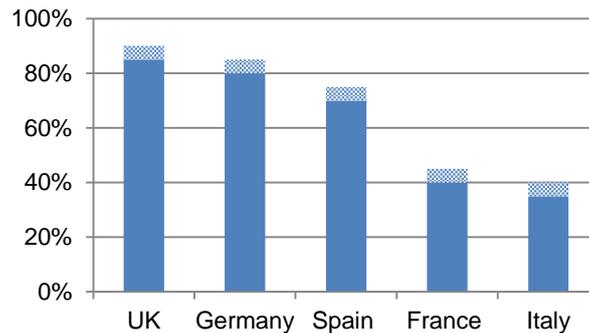
- 10. More specifically, in terms of NGA coverage, the UK leads the EU-5 as shown below:

⁶⁶ Para. 1.8, February 2016 Statement "*While the UK compares favourably to similar-sized countries in Europe on availability 1.8 and price, more investment is needed to enable a step change in the speeds and technology available to consumers.*"

⁶⁷ The Digital Economy & Society Index (DESI), at <https://ec.europa.eu/digital-single-market/en/desi>.

⁶⁸ Coverage, take-up, speed and price.

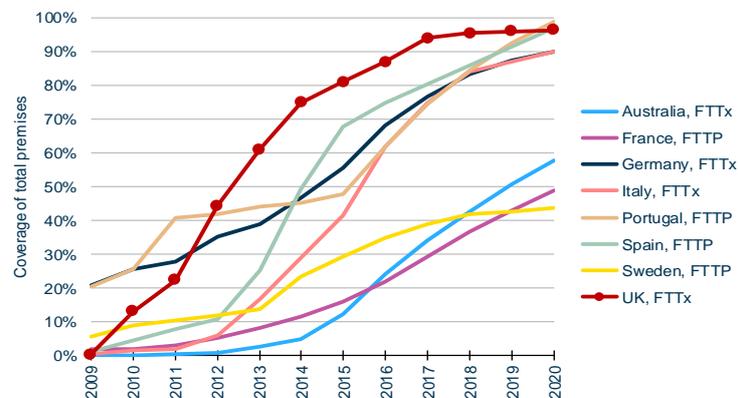
Figure 3.2.1.1 – Low (Blue bars) and High (Blue and grey bars) estimates of fibre coverage⁶⁹



3.2.1.2 Time series of deployment

11. Openreach also achieved the fastest deployment of an NGA network amongst benchmark countries as shown by the gradient of the coverage in the Figure below, in particular over the period 2009 to 2013.

Figure 3.2.1.2 – Coverage of NGA networks by incumbent operators⁷⁰



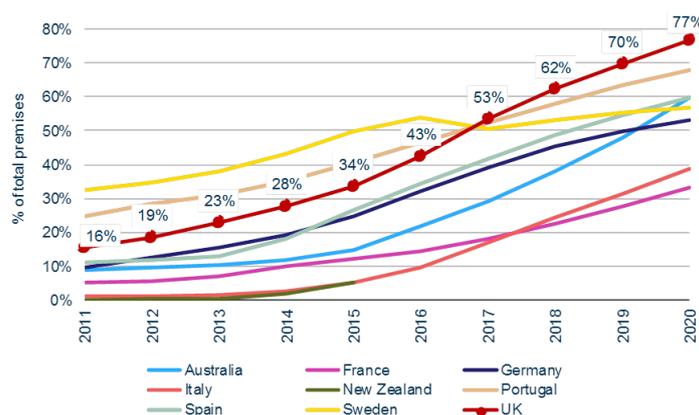
3.2.1.3 Take-up

12. In terms of take-up of fibre, Analysys Mason figures show that the UK has the highest take-up amongst the EU-5, and is projected to be higher than in many other Analysys Mason benchmark countries.

⁶⁹ The European Broadband Scorecard 2015 – Update, Ofcom, 4 March 2016.

⁷⁰ Comparative analysis of UK infrastructure and outlook for future development, Analysys Mason September 2016 Report, Figure 4.4.

Figure 3.2.1.3 – Benchmark of total NGA broadband take-up (premises connected as a percentage of total premises)⁷¹



13. It is noteworthy that whilst New Zealand has been held up as an exemplar that the UK should consider following, the UK leads New Zealand significantly in fibre take-up (by a ratio of around 3:1⁷²) and in actual speeds delivered to end-users⁷³, despite huge public subsidies provided by the New Zealand government.

3.2.1.4 29 Mbit/s line speed

14. In March 2016, Ofcom reported that average line speeds in November 2015 for the UK as a whole had reached 28.9Mb/s⁷⁴, up from 22.8Mb/s the previous year⁷⁵.

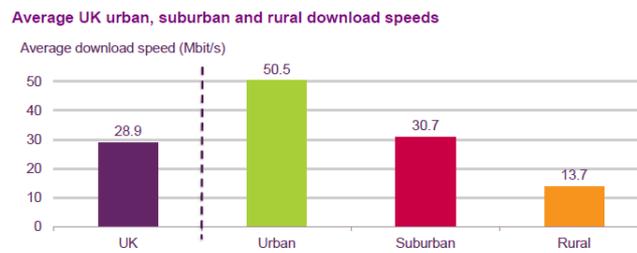
⁷¹ Analysys Mason (FTTx coverage, conversion and capex: worldwide trends and forecasts 2015–2020), 2016.

⁷² See the Australia and New Zealand section of Annex G, “Case studies of separation”, and the coverage estimates provided therein, drawn from New Zealand governmental sources and Ofcom material.

⁷³ Data Source: Akamai State of the Internet, Q1 2016.

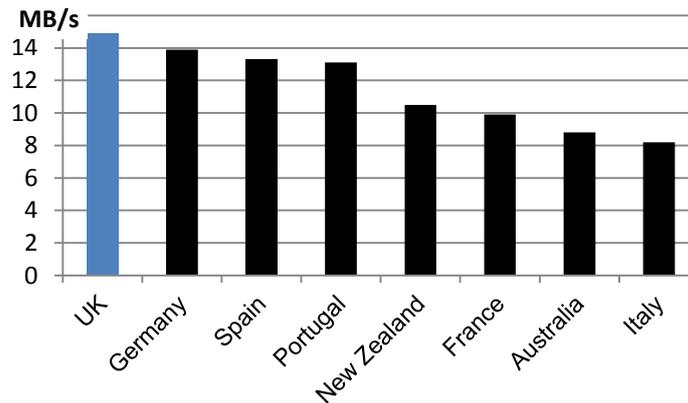
⁷⁴ Ofcom Report, UK Home Broadband Performance, March 2016, page 14 <http://stakeholders.ofcom.org.uk/market-data-research/other/telecoms-research/broadband-speeds/UK-home-broadband-performance-Nov-15/>. Line speeds cited by Ofcom differ from Akamai data (used to indicate average internet comparative speed below) because the latter measures effective speed as recorded on Akamai servers. Differences arise for a variety of reasons, for example, a single line might be used by a number of users at the same time or there might be speed constraints attributable to backhaul.

⁷⁵ November 2014 Ofcom Report.

Figure 3.2.1.4 – Average UK download speeds

3.2.1.5 Speed

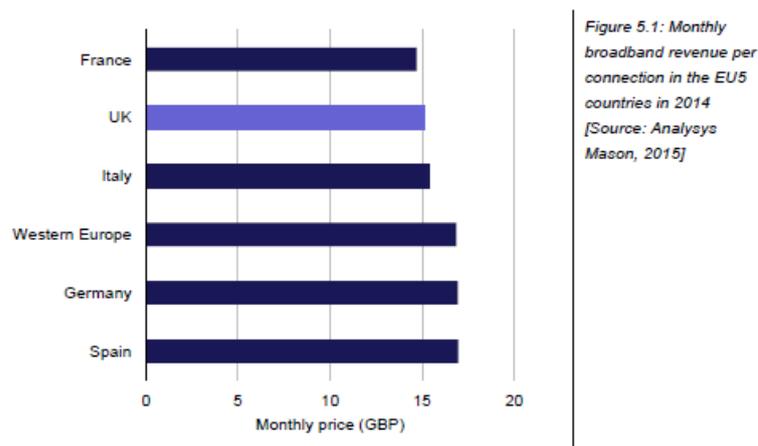
15. Broadband speeds in the UK also exceed those in the other EU-5 as shown below.

Figure 3.2.1.5 – Average internet comparative speeds⁷⁶

3.2.1.6 Prices

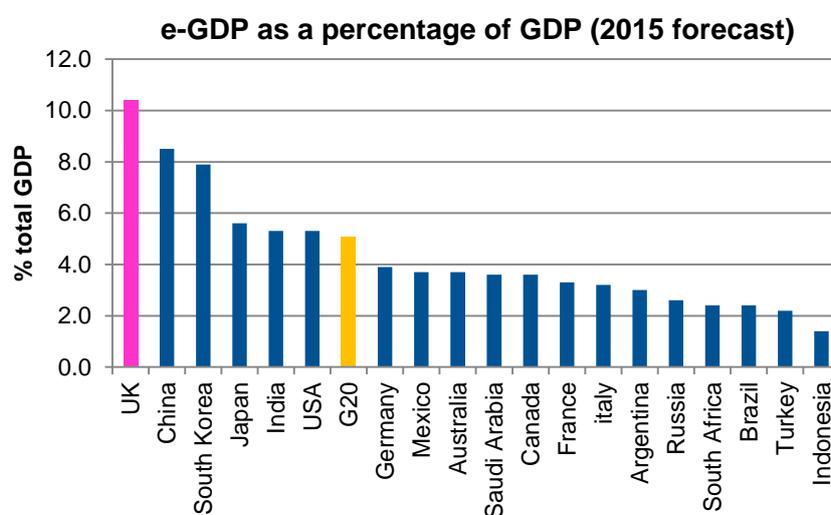
16. Whilst providing faster internet connection speeds, the UK retail prices are lower than in Germany, Italy and Spain and only very slightly higher than in France, as shown in Figure 3.2.1.6 below.

⁷⁶ Data Source: Akamai State of the Internet, Q1 2016.

Figure 3.2.1.6 – Retail prices for broadband services⁷⁷**3.2.1.7 Wider internet economy**

17. Studies also place the UK at the top in terms of the extent of its “e-economy”. For example:

- The UK has a higher level of internet usage than in other major EU countries;⁷⁸
- Boston Consulting Group estimate that the UK has the largest internet economy as a proportion of the national economy amongst all G20 countries.⁷⁹

Figure 3.2.1.7 – e-GDP as a percentage of GDP (2015 forecast)

⁷⁷ International benchmarking report, Analysys Mason, 21 September 2015.

⁷⁸ Eurostat survey data, 2014.

⁷⁹ Source: Boston Consulting Group, May 2015.

- A June 2016 Report by McKinsey & Company placed the UK just behind the US in terms of its “digital intensity” (defined by McKinsey as the degree to which digitization drives sectors and firms) and ahead of all European countries they included.⁸⁰
 - A June 2016 Report by the World Economic Forum included the UK in its 10 countries that are best placed to make the most of the new digital world, based on an index designed to measure how well an economy is using information and communications technologies to boost competitiveness and well-being.⁸¹ The only large country placed ahead of the UK was the United States, by a small margin. The UK is also out-performing many countries which have heavily subsidised FTTP technology.
18. As such reports make clear, a successful digital-economy requires far more than just fast and reliable network services, but it is clear that the UK has the networks that enable the country to perform well in such studies.
19. BT is not complacent and recognises that a continuing programme of investment will be needed to maintain the UK’s international competitiveness. However, the evidence above demonstrates that both infrastructure-based and resale-based competition are working effectively in the UK, with increasingly strong access competition **to** Openreach and strongly established retail competition **based on** the Openreach network. Overall, the UK has a strong performance when assessed against its peers.
20. Accordingly, the UK market cannot be described as one suffering from regulatory failure or ineffective competition. Further, as explained in more detail below, there is no justification for Ofcom’s intervention on the basis of any important and persisting competition problem in terms of wholesale access.

3.2.2 Competition in relation to wholesale access is exceptionally strong

21. Exceptionally positive market outcomes for consumers in the UK are founded on the strength of competition based on regulated wholesale-access to Openreach’s network.

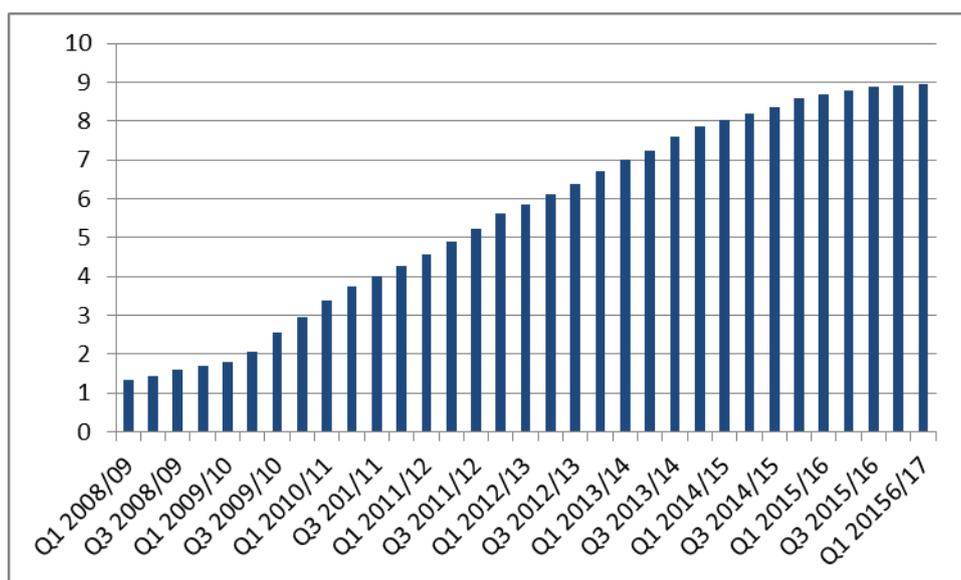
3.2.2.1 LLU take-up

22. The number of LLU lines has increased year on year and, as shown below, the number has almost doubled in the past five years to nearly 9 million lines. Ten years ago there were approximately 500,000 LLU lines⁸².

⁸⁰ McKinsey Global Institute, Digital Europe: Realizing the continent’s potential, June 2016

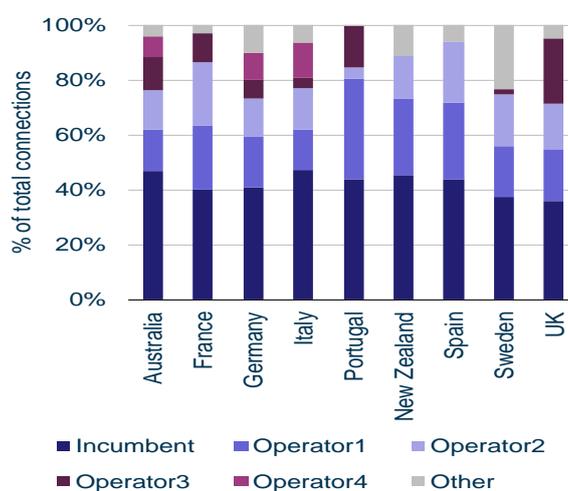
⁸¹ Information Technology Report 2016.

⁸² BT Annual Report & Form 20-F 2007, page 18.

Figure 3.2.2.1 – Growth in LLU lines (millions)⁸³

3.2.2.2 Low incumbent share

23. On the basis of equal access to Openreach's network, both copper (LLU) and fibre (VULA), rival operators have grown from under 2% to over 40% of the market since 2005,⁸⁴ a track record that is unmatched in any other European country.

Figure 3.2.2.2(i) – Analysys Mason 2016 Report

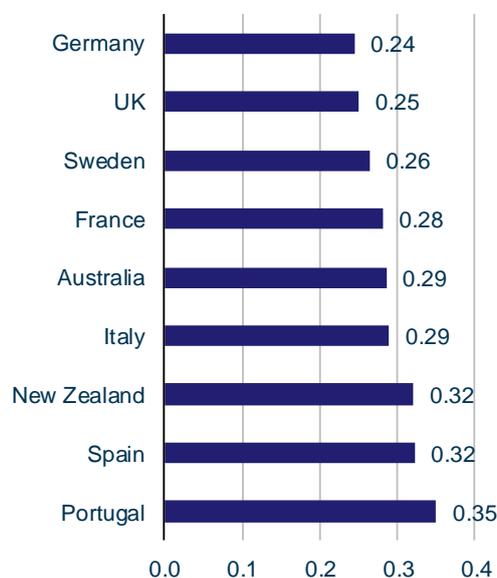
24. This is hardly evidence of market failure or lack of competition resulting from inadequacies of standard SMP regulation. On the contrary, the competitiveness of the UK market is, on all reasonable measures, already

⁸³ Source BT KPIs from <http://www.btplc.com/Sharesandperformance/Calendar/index.htm>

⁸⁴ Para 1.13, July Consultation.

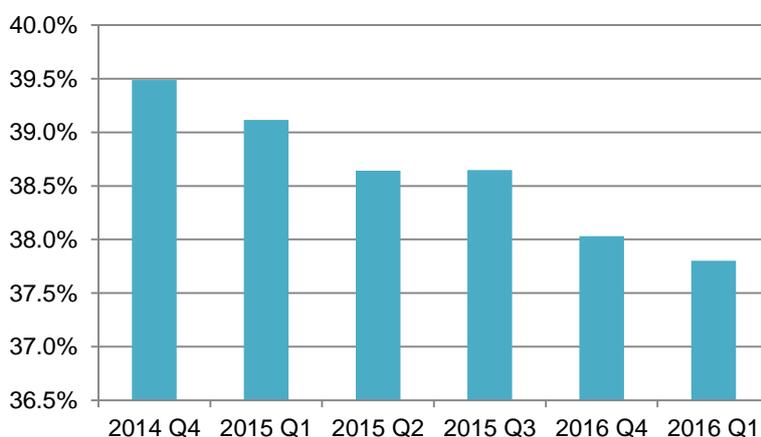
exceptionally strong by comparison with other European countries. BT's share of retail broadband connections is 36%, which is the lowest of any incumbent in the EU. As Analysys Mason show⁸⁵, the UK has the second-lowest Herfindahl-Hirschman Index (HHI) score⁸⁶ amongst their benchmark countries.

Figure 3.2.2.2(ii) – Herfindahl-Hirschman Index measure of market concentration



As shown below, BT continues to lose share at the retail level and now accounts for under 38% of all fixed lines.

Figure 3.2.2.2(iii) – BT share of all exchange lines⁸⁷



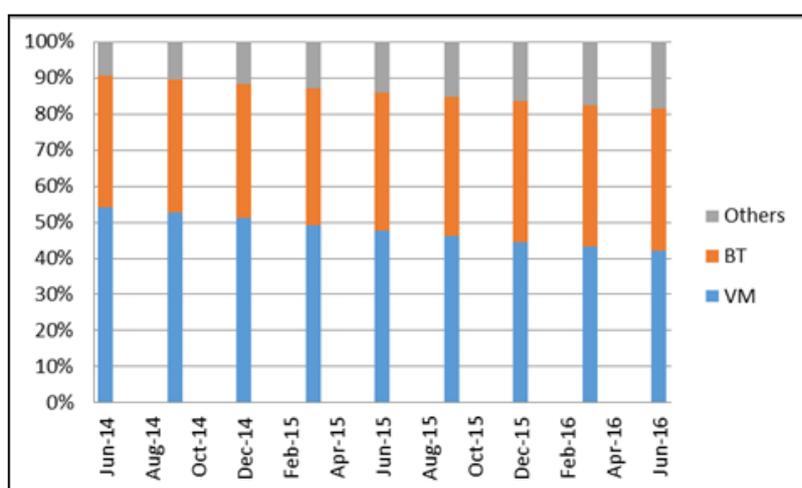
⁸⁵ Figure 4.10, Analysys Mason 2016 report.

⁸⁶ The Herfindahl-Hirschman Index (HHI) is a measure of market concentration. The lower the score, the lower the concentration of the market (and therefore the higher the levels of competition).

⁸⁷ Ofcom Telecommunications Market Data Update Q1 2016, published 11 August 2016

25. BT addresses claims from certain CPs that competition for superfast fibre-based broadband services is less intensive than for standard speed copper-based broadband services in Annex I. Different broadband providers have pursued different commercial strategies since Openreach began to supply VULA, alongside copper access, on Eol terms in 2009/10. The relative mix of customers taking standard versus those taking superfast speeds therefore differs between providers. The largest number of high-speed broadband connections are supplied by Virgin Media (about 4.8 million at the end of June 2016; over 40% of the total). The non-BT share of net VULA adds on the Openreach network has been increasing as commercial strategies evolve, and thus shares of these operators have been growing as shown in the chart below as the upper grey bar.
26. For example, Sky has recently announced a new service “Fibre Max” which offers headline speeds up to 76Mbps, double Sky's previous fastest broadband product. Sky Fibre Max does not require a customer to purchase Sky TV, widening its potential appeal. In its 2016 Annual Report, Sky reported increased fibre penetration (alongside continued strong growth in customers) over the past 12 months.⁸⁸

Figure 3.2.2(iv) – Market share of high-speed broadband⁸⁹



27. In summary, competition based on wholesale access to Openreach is exceptionally strong by comparison with other European countries.
28. Furthermore, there is no reason to believe that this exceptionally strong competitive environment is under threat of weakening. Not only is access-based competition flourishing, but the prospects for infrastructure based competition are good, as discussed in the next section.

⁸⁸ Sky Annual Report 2016, page 25, at <https://corporate.sky.com/documents/annual-report-2016/annual-report-spreads-2016.pdf>.

⁸⁹ Derived from Enders Analysis data with permission.

3.2.3 Infrastructure-based competition is already strong and growing

3.2.3.1 Customers joining VM

29. Competition is already strong and growing at the infrastructure / access network level as well as the retail level based on wholesale access. Competitors are not standing still.
30. In particular, Virgin Media competes in the self-supply of access to approximately 45% of all households and is already in the process of increasing this coverage through its recent expansion (namely Project Lightning).⁹⁰ It is investing £3bn to expand its high-speed broadband network (offering download speeds of up to 200Mb/s) which will reach 17 million homes and business in the UK⁹¹, taking its coverage to over 60% of all premises.
31. The Virgin Media network is a faster network than BT's Openreach network which has proven itself to be strong competition to BT.
32. Virgin Media explains the advantages of its offering (under the heading "Ultrafast broadband up to 300 Mbps") as follows:

"For local residents, Virgin Media's Vivid 200 broadband is the best way to experience the internet – with download speeds of up to 200Mbps. This is more than two and a half times faster than the top widely available speeds from BT, TalkTalk and Sky meaning that a whole household can stream movies, music and more all at the same time. For local businesses, Virgin Media Business now offers ultrafast connectivity as standard, with speeds of up to 300Mbps – almost four times faster than its main competitors' widely available top speeds. This enables businesses to reach their potential by delivering better services and greater capacity."
33. Recent press reports indicate that Virgin Media is seeking approval for further funds to increase its coverage to two-thirds of UK premises.⁹² This would make its coverage commensurate to almost the whole commercial fibre footprint of BT in the UK.
34. At the same time, new entrants are also starting to emerge. New operators include CityFibre, which is targeting "second tier" cities (including Aberdeen, Coventry, Edinburgh, Glasgow, Peterborough and York), building ultra-fast,

⁹⁰ Virgin Media DCR main response, page 17.

⁹¹ Virgin Media announces largest UK fibre broadband rollout, 27th April 2016
<http://www.virginmedia.com/corporate/media-centre/press-releases/virgin-media-announces-largest-uk-fibre-broadband-rollout.html>

Network expansion is to take place in Berkshire, Buckinghamshire, Derbyshire, Dorset, Glamorgan, Hampshire, Leicestershire, North Yorkshire, Oxfordshire, Renfrewshire, Rhondda, South Yorkshire, Staffordshire, Surrey, Warwickshire, West Lothian, West Yorkshire and Worcestershire.

⁹² "Virgin Media takes fight to BT with new investment", Sunday Telegraph, August 28th, 2016.

pure fibre networks.⁹³ It has been reported in the press that CityFibre, “has almost tripled its revenue - boosting its status as the biggest rival to BT Openreach... as well as vastly extending its reach to 40 towns and cities through acquisitions [including through a £5m acquisition of 137km of ducts and fibre networks from Redcentric].”⁹⁴ Other entrants include Hyperoptic (main cities) and Gigaclear (rural premises) who are also investing in their own access network projects. These new entrants may presently be limited competitors, but the scale of their ambition is evident and there is no reason to doubt that over the next few years they are likely to start to become significant competitors to BT and Virgin Media. Indeed, BT notes that Ofcom also anticipates the potential emergence of one or more new infrastructure providers providing access to around 40% of premises.⁹⁵ Against this backdrop, any suggestion that competitive access markets will not develop in the foreseeable future is unfounded.

35. This competition, historically from Virgin Media but increasingly from other fibre competitors, has already had significant beneficial market effects, resulting in a wider choice of providers and range of differentiated services for consumers in the UK. BT has had to respond both by improving its network access products and its overall retail offering. In terms of the access market particularly, Ofcom highlights these market dynamics very clearly (emphasis added):

⁹³ “CityFibre will commence its deployment in Glasgow city centre early in 2016, with the intention to ultimately deliver the huge benefits of pure fibre connectivity to the whole city. The new Gigabit City fibre network will transform the city’s digital infrastructure, supporting internet connectivity up to 100 times faster than the UK average. The state-of-the-art network will also future-proof the city as the thirst for greater bandwidth continues to grow exponentially, from all sectors, over the coming decades. The first phase of deployment will comprise a dense network build in Glasgow city centre...Up to 7,000 city centre businesses will be within close reach of the fibre network and within the year, will be able to access a new generation of ultra-fast services through HighNet’s extensive channel partner network. Ultimately up to 15,000 businesses across the city will stand to benefit when the full city-wide roll-out is completed. As with CityFibre’s other Gigabit City projects in Aberdeen, Coventry, Edinburgh, Peterborough and York, the network will be deployed in-line with the company’s ‘Well Planned City’ model. This design approach accommodates current and future capacity requirements from the business community, public sector, mobile operators and datacentre providers. Ultimately, the network could form a backbone for a future deployment of a gigabit-capable fibre-to-the-home access network.” “Glasgow Becomes Scotland’s third Gigacity”, <http://www.cityfibre.com/news/2015/11/25/glasgow-becomes-scotlands-third-gigabit-city>

⁹⁴ <http://www.telegraph.co.uk/business/2016/09/26/cityfibre-triples-sales-as-it-plugs-more-uk-cities-into-its-broa/>. In December 2015, CityFibre announced that it had acquired Kcom’s national network for £90m, which it described as a “transformational acquisition”, creating a “vastly expanded footprint” (comment of CityFibre’s CEO on completion of KCom acquisition, 18 January 2016, available at: <https://www.cityfibre.com/news/2016118comment-on-completion-of-cityfibres-90m-acquisition-of-kcoms-national-fibre-assets/>).

⁹⁵ Para. 1.4, July Consultation. The emergence of new infrastructure providers is not dependent on the choice of separation model for Openreach, nor has Ofcom suggested this is the case.

“As set out in our Discussion Document, it has historically been competition from cable that has played a greater part in driving network upgrades. In the early 2000s, one of the factors that drove BT to increase the performance of its initial broadband service was the availability of cable broadband. Similarly, BT announced its rollout of superfast broadband shortly after Virgin Media’s upgrade to DOCSIS 3.0. BT’s recent announcement of G.Fast investment plans was in the context of Virgin Media offering a maximum service speed of 200Mbit/s compared to a maximum of 80Mbit/s available from Openreach for VULA.⁹⁶”

36. Ofcom recognises, therefore, the dynamic nature of competition, including at the infrastructure / access network level, with increasingly better performing services being deployed in the UK as suppliers innovate and respond to the upgrades of their rivals.
37. For its part, BT has long recognised that year on year consumers are consuming ever increasing amounts of data and that this will continue for the foreseeable future. It is well aware of the need to ensure that its network meets their needs and expectations. BT has responded by planning for further investment to increase coverage and speed of its fibre access services, including providing “ultra-fast” broadband (of 100Mb/s and above) to 12 million UK premises by 2020.⁹⁷ This will enable it to both meet the needs of its customers and to meet the challenge posed by competitors such as Virgin Media and the new entrants who are doing the same.
38. The benefits of competition between BT and Virgin Media (and increasingly third party competitors), as described above, also provides market opportunities for CPs who have not to date made significant investments in their own access networks, because Openreach’s network upgrades are required to be made available to all CPs (including BT’s own retail businesses) on a strictly non-discriminatory equal access basis. This allows external CPs to benefit from all investment made in response to competition by BT in Openreach, and to choose if and when they intend to market any new retail service based on BT’s upgraded network. In making such a decision, CPs are in exactly the same position, and have exactly the same opportunity, as BT’s retail divisions. Just as fibre based retail broadband services are already being sold and marketed successfully by non-BT CPs, so equally in future, newer and faster broadband services using new access technologies will be sold successfully by competing non-BT retailers.
39. In addition to the competition from Virgin Media and other network providers, BT agrees with the need to raise the minimum universal broadband service across the UK network in line with Ofcom’s proposed 10Mb/s and has offered to provide that minimum. BT has accepted that it has a major role in discharging

⁹⁶ Para. 4.11, Initial Conclusions.

⁹⁷ BT Press Release 5 May 2016.

that public service obligation which, if delivered by BT, would again benefit its retail competitors in exactly the same way as BT's own retail division.

40. The evidence shows that the UK has no persistent “competition deficit” either in relation to the use of wholesale access or in relation to the infrastructure level. The UK has more competition than in any comparable country, and the prospects for greater competition across the whole value chain, are very good as BT responds to competitive pressures and to obligations in relation to minimum universal service levels.

3.3 The current regulatory regime has been remarkably successful

41. Ofcom accepts that the existing functional separation and equal access regime have “*achieved good outcomes*”⁹⁸ and “*market successes*”⁹⁹ in terms of preventing discriminatory wholesale access to inputs. It acknowledges that the existing regime has “*broadly addressed*” the concerns relating to discrimination identified in 2005¹⁰⁰. This evidence should be sufficient for Ofcom not to intervene further.¹⁰¹
42. As set out in detail in the previous sections, the beneficial market outcomes generated for consumers, the strength of competition based on wholesale access and the strong and growing competition to Openreach at the infrastructure level in the UK all clearly demonstrate that the Undertakings and the existing SMP regime have been notably successful and have achieved dynamic and vigorous retail competition between BT and its retail and infrastructure rivals.¹⁰² There is nothing to suggest that the prognosis for the future is not equally good.
43. Art 13a/S.89A is an exceptional measure which only permits Ofcom to intervene where it can provide evidence justifying a conclusion that existing regulation has failed to achieve effective competition. These stringent conditions have not been satisfied: Ofcom has provided no evidence of ineffective competition or regulatory failure. Nor has it set out a properly reasoned assessment of the actual conditions of competition nor the success of regulation in the market.

⁹⁸ Para. 3.12, July Consultation. Similarly, other CPs have noted that, on a day-to-day basis, BT does supply EoI products in accordance with its obligations “Sky did acknowledge that there was no day-to-day discrimination by Openreach between service providers.” Nomura, Quick Note - UK Telecom Regulation - The case for Openreach separation, October 02, 2015.

⁹⁹ Para. 6.47, Initial Conclusions.

¹⁰⁰ Para. 1.13, July Consultation.

¹⁰¹ See Annex D, “*Alleged persistent problems of discrimination – Compliance with the Undertakings*”

¹⁰² It is clear that the Undertakings are to be included as part of the existing regulatory regime: see *BT plc v Ofcom and Others (non-specified price controls)* [2016] CAT 3 at [147]. This interpretation is also supported by a former economist from the EU Commission: see pages 14-17, Shortall Review.

44. Market failure would suggest that the existing regime has been inadequate, resulting in a lack of effective competition and/or that market outcomes (in terms of price/quality and choice of services) are being compromised for end-users. As the Shortall Review indicates, an assessment of the state of competition on the market requires an assessment at the retail level before turning to the wholesale market¹⁰³. Secondly, given that this is intended to be an *exceptional remedy* within the EU, one would expect Ofcom to produce compelling evidence of market outcomes and conditions of competition being materially worse in the UK than those observed in other Member States if it were to justify such exceptional regulatory intervention.
45. However, there is no evidence that there are persistent competition problems or that consumers in the UK are suffering poor market outcomes. In fact, the evidence of competition and market outcomes shows **precisely the opposite**, i.e. that the conditions of competition on the UK market are exceptionally dynamic.
46. In its July Consultation, Ofcom accepts that the existing functional separation and equal access regime in the Undertakings has “*broadly addressed*” the concerns relating to discrimination identified in 2005¹⁰⁴, and it states that:
- “Today, SMP obligations and the Undertakings have achieved good outcomes by preventing BT from supplying inferior products and services to its competitors compared with its own retail businesses.”*¹⁰⁵
47. In fact Ofcom’s rigour in developing and enforcing SMP regulations is widely considered to be among the most diligent among European National Regulatory Authorities. On top of the full set of fully enforced regulations, Ofcom also has the benefit of the Undertakings offered by BT in 2005 to bring about functional separation and equal access. No allegations have been made that equal access to Openreach’s products has in any way failed to deliver equal access to the products provided in regulated markets by Openreach (nor indeed by BT Wholesale) throughout the entirety of Ofcom’s strategic review. It is safe to conclude that they have been highly successful.
48. There is no market on which Openreach operates and on which Ofcom has failed to impose at least one highly effective wholesale access remedy. Indeed on the three large scale access network product markets – copper lines, fibre broadband lines and Ethernet lines – Ofcom typically imposes more than one wholesale access remedy:

¹⁰³ Pages 13-14, Shortall Review and Commission Staff Working Document SWD (2014) 962.

¹⁰⁴ Para. 1.13, July Consultation.

¹⁰⁵ Para. 3.12, July Consultation. Similarly, other CPs have noted that, on a day-to-day basis, BT does supply EoI products in accordance with its obligations “Sky did acknowledge that there was no day-to-day discrimination by Openreach between service providers.” Nomura, Quick Note - UK Telecom Regulation - The case for Openreach separation, October 02, 2015.

- a. In copper broadband, Openreach is obliged to provide both MPF and WLR on equal access terms. BT Wholesale is obliged to provide wholesale broadband access on equal access (and price regulated) terms in market A;
 - b. In fibre broadband, Openreach is obliged to provide both passive infrastructure access and Virtual Unbundled Local Access (VULA, fulfilled by the GEA product);¹⁰⁶ and
 - c. In Ethernet markets, Openreach has been obliged for some years to provide wholesale access to its Ethernet Access Direct service (EAD) on equal access (and price regulated) terms and will from October 2017 be obliged to provide a dark fibre access product as well.
49. In all cases, external CP customers of Openreach benefit from a fully effective wholesale access product which supports their ability to compete on equal terms with BT's own operations in the retail markets. As is clear from this short summary, there is no lack of effective wholesale access regulation in the UK. On the contrary the problem in the UK is one of multiple overlapping or evolving competition and regulatory objectives (raising the question as to whether active service based competition, or infrastructure based competition are the prime goal), which sometimes leads to tensions between conflicting wholesale access regulations. In addition, the implementation of the Broadband Costs Reduction Directive 2014/61 now provides further opportunities for duct infrastructure access (from BT and other infrastructure owners) as has happened in France, Spain and Portugal. Ofcom itself sees infrastructure competition increasing with FTTP developing through infrastructure access¹⁰⁷.
50. As the Shortall Review comments, there is, therefore, a "logic-gap" in Ofcom's approach.¹⁰⁸ Given the recognised tension between service competition and infrastructure competition, Ofcom's proposed recourse to functional separation will undermine infrastructure investment. That is the very reason why Art 13a AD should not be used where infrastructure based competition remains possible.
51. It is clear that Ofcom has not conducted any "internal review" as required by the BEREC Guidance, prior to initiating the imposition of its extreme form of functional separation for such a novel and unprecedented concern as the "strategic discrimination" identified by Ofcom. In particular, BEREC emphasises the need not only to impose the standard SMP remedies but also to enforce them systematically. It also advocates that a "reasonable amount of time" will

¹⁰⁶ Openreach is required to supply VULA on equal access terms and BT is subject to a margin squeeze test, which protects competitors to BT by requiring BT to maintain adequate margin between the price of VULA and the prices charged by BT Consumer on the competitive retail broadband market.

¹⁰⁷ Para 4.4 et seq, July Consultation

¹⁰⁸ Page 18, Shortall Review.

need to pass between their imposition and the conclusion that functional separation is necessary¹⁰⁹.

52. Ofcom has not even attempted recourse to the standard SMP obligations in Articles 9 to 13 or attempted to use other ancillary measures such as internal procedures or Key Performance Indicators systematically across all parts of the access markets, as recommended by BEREC. Nor has Ofcom collated a “substantial track record of enforcement activity” regarding any alleged instances of strategic discrimination. Without having undertaken such tasks, the requirements of “exceptionality” have not been met and resort to functional separation cannot be justified.
53. Given the intrusive and costly nature of functional separation, the burden of proof rests with Ofcom to demonstrate the need for such intervention as an “**exceptional measure**”.¹¹⁰ It is a “**measure of last resort**”¹¹¹, that is only to be used when it can be proved that the wholesale obligations in Article 9 to 13 of the Access Directive will not be sufficient to alleviate the competition problems in the market place and, by definition, that functional separation is the “**sole remedy**” that can do so¹¹². No such proof has been offered or any internal review attempted.

3.4 There are no important and persisting competition problems

54. The Article 13a requirement on Ofcom to demonstrate important and persisting competition problems means that it must provide evidence of actual significant competition problems, which have a persistent character, from both a historical and prospective perspective.¹¹³ Further, the concerns must be sufficiently recurrent and important to conclude that they cannot be resolved through ordinary SMP regulation and therefore warrant the much more costly and intrusive measure of functional separation.¹¹⁴
55. Yet neither the Initial Conclusions nor the July Consultation identify any “track history” that would qualify for the purposes of Article 13a. The issues raised by a number of CPs (who are also competitors of BT) are unevidenced and self-serving assertions (as discussed in Annex I); and the purported “problems” identified by Ofcom itself are theoretically weak and also unsupported by evidence. The Initial Conclusions and July Discussion Document are wholly inadequate to establish a jurisdictional basis for Ofcom to intervene in accordance with Article 13a or ss. 89A and B.

¹⁰⁹ Ibid.

¹¹⁰ BEREC Guidance. Page 8.

¹¹¹ BEREC Guidance, page 9.

¹¹² Ibid. See Also Regulation 61 of the Better Regulation Directive and Ofcom’s duties in Article 8(1) and 8(5) of the Framework Directive to adopt targeted, proportionate ex ante measures where there is no effective and sustainable competition.

¹¹³ BEREC Guidance, page 14.

¹¹⁴ BEREC Guidance, pages 13-15.

3.4.1 Stakeholder concerns validly dismissed by Ofcom

56. Ofcom rightly dismisses a number of issues that have been raised by stakeholders or by Ofcom itself over the course of the review, on the basis that they do not raise competition issues and/or can be addressed through current regulation and do not justify further separation.¹¹⁵ Given that the stakeholders who have provided the positions below are, in most instances, the CPs that compete with BT downstream in the retail market, it should be noted that they have every incentive to allege ongoing difficulties and failures by BT and Openreach in order to use the regulatory process to their commercial benefit.
57. By way of summary, the key allegations and Ofcom's response are summarised below (as well as BT's observations):

- **Allegation that Openreach's revenues have been used to finance other activities within BT Group (e.g. the purchase of rights for BT Sport).** BT has repeatedly demonstrated that as a matter of fact this is not true. As a matter of principle, Ofcom has made it clear that "*If profits are earned fairly, i.e. in accordance with regulation and competition law, BT has the right to invest those profits as it sees fit, again, as long as this is in accordance with regulation and competition law*".¹¹⁶

In fact, BT's consumer division earns over £700m of free cash flow a year after paying for the costs of sports rights. It earns more free cash-flow a year now than it did before it started making investments in sports rights. There is no basis for alleging that Openreach's revenues have been used to support sports rights acquisition. And, as Ofcom acknowledges, even if it had, there would be no issue.¹¹⁷

- **Specific allegations of price discrimination (e.g. raising prices of wholesale services used more by other CPs and less by BT Consumer, volume discount structures, etc.)** The vast majority of Openreach's revenues (over 90%) are subject to SMP regulation and the vast majority of these (around 80% of revenues) are subject to charge controls. BT considers that circumstances where BT might be incentivised to set charges for different services in such a way as to favour downstream BT do not typically arise, because all CPs buy essentially the same inputs from Openreach, namely, copper and fibre connectivity. The only instance in which BT buys significantly different products from other CPs is the result of regulatory requirements. BT's downstream operations were obliged by Ofcom to consume WLR and SMPF (an inferior product experience with inferior Care Levels) from Openreach until very recently, while LLU operators consume MPF for copper connectivity (a better product experience with a better Care Level). If BT had the incentive and ability to discriminate, one would

¹¹⁵ Para. 6.12, Initial Conclusions.

¹¹⁶ A1.168 FS

¹¹⁷ Ibid at [105]

have expected BT to prioritise investment in the product BT consumes, WLR, over investment in MPF. In fact one finds the opposite: BT is committed to withdrawing WLR completely by 2025, subject to regulation. But, even if any such incentives did exist (which BT does not accept), Ofcom is fully able to address any potential short term discrimination through the market review process: *“We recognise that as a vertically integrated firm, BT has the incentive to set wholesale charges which favour products used proportionately more by BT’s downstream businesses than its competitors. We consider this incentive and seek to limit BT’s ability to act on it when assessing how broad baskets should be in the context of a charge control.”*¹¹⁸. BT therefore agrees with Ofcom that it was right to disregard the allegations made by other CPs in this regard.

- **Allegations that BT Group had discriminated against other CPs through the Statement of Requirements (“SOR”) process:** Ofcom does not regard this as a significant discrimination concern, and considers that any issues can be addressed by normal SMP regulation. It states *“Our analysis did not find any significant differences in SOR acceptance rates and completion times between products or between downstream communications providers including BT. We did find that Openreach accepts a significantly higher proportion of its own SORs than of downstream communications providers. There are a number of legitimate reasons why this may be the case.”*¹¹⁹ The Openreach SOR process is run on an EoI basis. CPs are able formally to request the introduction of a new product, or a change to an existing one within the Openreach product portfolio. Openreach evaluates each request and provides the same commercial information to all customers (whether within BT Group or third parties) with no priority given to any customer. Acceptance of a SOR request is based on whether there is an objective business case, not on the identity of the requesting CP.¹²⁰
- **Stakeholder concerns about the level of BT’s returns in regulated markets:** Ofcom states, *“As set out in the Discussion Document, BT’s returns were in part due to our policy decisions. More recently, much of the gap has been due to relatively high returns in business connectivity markets. We set out the reasons for this in the July 2015 leased lines charge control consultation. We will shortly be setting new prices in these markets.”*¹²¹ BT requested a review of this issue by EY as

¹¹⁸ A1.180, Initial Conclusions.

¹¹⁹ A1.186, Initial Conclusions.

¹²⁰ As regards the question of whether there is sufficient transparency for CPs to assess whether Openreach accepts or rejects SORs on the basis of an objective business case (which Ofcom is considering), Openreach ensures transparency of the SOR process through the Openreach SOR Management Tool, which is available to all customers. This enables customers to enter product requirements, view active and historic SORs, and vote to support or not support a request and to provide accompanying evidence.

¹²¹ A1.374.

described in their report attached to this submission. EY found that the difference between charges and costs for all services subject to direct price controls (including external and internal sales) was £1.1bn over a ten year period (2005/6 to 2014/15). EY estimate this to be equivalent to paying a margin above cost of about 2.2% and 1.3% on external sales only. Looking at those services provided by Openreach, EY found that, on services subject to direct price controls sold to external customers, Openreach actually made a small *loss* of £20m over the period.¹²² Higher margins were made where, although subject to SMP regulation, direct price controls were not applied by Ofcom. Such decisions were primarily made with longer term goals in mind, particularly to encourage entry and investment into fixed telecoms. Ofcom states in this regard, “*Our regulatory approach is designed to ensure there are appropriate incentives for firms to be efficient and to invest through principles such as the fair bet.*”¹²³

- **“Ten point plan”:** A number of BT’s competitors, including Sky, TalkTalk and Vodafone have put forward a “ten point plan” on revisions required to the current regulatory framework, including ideas on how to legally separate Openreach from BT. These companies base their case for separation on concerns raised previously about BT’s performance in recent years and focus largely on unfounded allegations that BT has not invested sufficiently in fibre technologies and that the UK is lagging behind other countries. As the evidence above shows, Ofcom is right to dismiss these contentions, in relation to consideration of the right model of governance for BT. BT has conducted a more detailed review of the main points raised by CPs, particularly those explicitly claiming that vertical integration creates competition problems and calling for increased Openreach independence. BT’s review is set out at Annex I. As this Annex demonstrates, the submission of various CPs revealed differences in opinion on how well the market has been performing, what regulatory change is warranted and on the strategic direction that Ofcom should pursue. The Annex shows that the submissions are largely based on assertions, contain numerous factual inaccuracies and tend to discuss issues which are **unrelated** to Openreach’s independence.
- **BT Northern Ireland:** Ofcom recognises that the governance arrangements in Northern Ireland differ from the rest of the UK. Ofcom has reviewed these arrangements and noted that “*whilst stakeholders have raised concerns about consumer perceptions of the arrangements in place, we did not receive evidence of any problems caused by the model throughout the course of our engagement.*”¹²⁴ It has therefore concluded that it would be inappropriate to require greater functional separation in Northern Ireland. BT supports this conclusion and

¹²² Para 3.19, EY Regulatory Profitability Report.

¹²³ A1.379

¹²⁴ Para. 4.94, July Consultation.

Ofcom's recognition that requiring functional separation would involve disproportionate costs. In Annex F, BT provides further detail of the way that BT Northern Ireland operates and highlights that the outcomes of the current integrated model of operation and governance have brought highly beneficial outcomes for competition and for consumers. Furthermore, it evidences that the compliance record in Northern Ireland and the level of performance there demonstrates that functional separation is not a necessary pre-requisite to the development of a good culture of compliance which is focussed on delivery of high class service and equivalent supply of services.

3.4.2 Concerns raised by Ofcom that can be addressed through SMP regulation or network competition

58. In several instances, Ofcom raises concerns that are not "competition problems in relation to wholesale access", properly defined, nor do they warrant further intervention in the form of extreme functional separation. To the extent that they exist at all, these are issues that are most appropriately and effectively resolved through existing regulation.

3.4.2.1 Cost Allocation concerns

59. In its Initial Conclusions document, Ofcom states: "*BT will always have the incentive to choose attribution rules that increase the reported cost of regulated services or favour its downstream divisions compared to other competitors. Despite the steps described above, the complex nature of BT's regulatory accounts, and inherent information asymmetry mean that the risk of inappropriate allocations going undetected cannot be entirely avoided.*"¹²⁵ However, this issue is not mentioned in the July consultation and therefore it is assumed that it is no longer being pursued as a serious concern or in support of Ofcom's Proposals.
60. In any event, Ofcom has more than adequate regulatory tools which can be used to monitor and respond effectively and proportionately to any issues in this regard. In particular:
- Ofcom imposes one of the most comprehensive accounting separation regimes in the world on BT, with the highest degree of detail and transparency for all CPs. Further these regulatory accounts are audited by auditors with a dual reporting responsibility, to Ofcom as well as to BT;
 - Ofcom has recently exercised its powers to determine the cost allocation methodologies used by BT.¹²⁶ So BT no longer has the power

¹²⁵ Para. 6.46, Initial Conclusions.

¹²⁶ In its Regulatory Financial Reporting Final Statement (20 May 2014), Ofcom stated that the changes it was making would:

'(i) give Ofcom a greater role in the way that BT prepares its regulatory financial statements; (ii) improve the presentation of the published regulatory financial statements and supporting

to allocate costs in the way that Ofcom fears, facing the certainty that Ofcom will over-rule any allocations that Ofcom deems inappropriate;

- In every charge control that Ofcom has imposed on Openreach, Ofcom has adjusted the costs from those published in the Regulatory Financial Statements to define the set of costs that Ofcom thinks is appropriate to include in the costs stacks for the purpose of the charge control. Therefore, Ofcom's oversight means that it will only include costs allocated in the manner that it sees fit; and
- Ofcom has recently conducted a study of cost allocation using independent external consultants, who concluded that, while an alternative allocation might be more appropriate, BT had not acted improperly and that BT's cost attribution system is free from bias.¹²⁷

3.4.2.2 Customer consultation

61. Ofcom raises concerns about the extent to which BT consulted other CPs before taking specific network investment decisions as follows:

"In certain key cases, we consider that Openreach has not consulted in a sufficient, timely or transparent manner with all its customers, on matters that are of strategic importance to them, and to UK consumers and businesses. For example, our understanding is that BT Group made the initial strategic decision to invest in ultrafast broadband and adopt a particular technology without consulting Openreach's customers." (paras 3.26 – 3.27)¹²⁸

"Without effective and timely consultation with all Openreach customers, there is a risk that the interests of customers other than BT are neglected or not given appropriate weight. This is particularly important for significant decisions about the operation of Openreach and the future of its network, with the risk that demand from certain groups of consumers is not necessarily taken into account and therefore alternative approaches to investment are not fully tested." (para. 3.28)

62. Ofcom's concerns regarding consultation over ultrafast broadband plans are unfounded. As a matter of fact, whilst BT recognises that it will need to ensure that its network will continue to be able to meet the rising demands of customers, [§< . Furthermore, as a matter of fact, the decision to announce a long term vision for the access network in January 2015 was in response to a direct request that BT should do

documentation; and (iii) ensure that Ofcom and other stakeholders have the information that they need.' (p.1).

¹²⁷ Cartesian BT Cost Attribution Review, Redacted Version for Publication, 8th June 2015. Cartesian concluded, "Overall, Cartesian is satisfied that BT's cost attribution system is free from bias. However there are areas of weakness that BT could improve on. This is perhaps unsurprising given the scale and complexity of BT's cost attribution system."

¹²⁸ Paras. 3.6-3.7, July Consultation.

so from the then Chief Executive of Ofcom and following a similar suggestion from the government. In any event, it is untrue to say that there had been no discussion with CPs about G.Fast technology prior to this date. Moreover, as explained in Annex C, the process of consultation with CPs that has followed this vision statement has been conducted openly, transparently, and with extensive engagement with all interested stakeholders, consistent with the three stage process BT has designed and intends to implement in the future.¹²⁹

63. It is also noteworthy that Ofcom makes no claim that the alleged lack of consultation resulted in a technology choice which did not represent the interests and needs of all downstream customers.¹³⁰

3.4.2.3 Rollout of FTTP

64. It has been suggested by stakeholders that BT has under-invested in FTTP. Ofcom does not make any such allegation but in its Initial Conclusions, it highlighted concerns that the UK is “*notable for its very limited availability of ultrafast broadband services, including those based on fibre-to-the-premise (FTTP)*”.¹³¹ In the July Consultation, Ofcom states:

*“We also concluded that a step change is required in the outcomes delivered to consumers and businesses. Our ambition for the future is that more homes and offices receive ‘fibre to the premises’ (FTTP). This technology, which offers average broadband speeds many times higher than those of today, is currently available to just 2% of premises in the UK, compared to 60% and higher in world-leading countries.”*¹³²

65. However, the relative performance in relation to FTTP deployment is explicable by specific market conditions in each country. Enders recently summarised the position as follows, stressing the far superior economics of FTTC (and next generation G.Fast), and that this issue is unrelated to separation:¹³³

¹²⁹ See, in particular, Annex C, at Section C.5.1, which outlines the consultation undertaken by Openreach with CPs in relation to ultrafast broadband developments.

¹³⁰ Ofcom also points to a further generalised concern that the Undertakings left a lacuna in relation to consultation on major access network investments. *The Undertakings do contain provisions designed to address some of our concerns related to lack of consultation. However, these are specific to those major investments envisaged in 2005, in particular BT’s original next-generation core network. Since 2005, BT has moved its focus away from core networks and the majority of its strategic investment has been in access networks, which form the last mile connections to customers. Despite this change of focus, we believe the same intent and principles that applied to BT’s next-generation core network plans described above should clearly have applied to subsequent investment decisions. However, this has not occurred to the same degree.*” Para. 3.30. July Consultation.

¹³¹ Para. 4.2, Initial Conclusions.

¹³² Para. 1.15, July Consultation.

¹³³ Openreach: The Seventh Degree of Separation, Enders Analysis 4 August 2016

“The UK is lagging some countries on fibre-to-the-premises (FTTP) penetration, with the vast majority of its superfast broadband either fibre-to-the-cabinet (FTTC) or cable. However, the reason for this is the far superior economics of FTTC, which has played a major role in driving the improved coverage in the UK; countries that are rolling out FTTP are generally doing it because FTTC is not technically possible. FTTC speeds are lower than which can be achieved with FTTP, but they are as fast as the vast majority of consumers for the vast majority of their activities can practically use given web-server limitations, and further iterations which push fibre ever closer to homes (such as G.fast) can meet future requirements. FTTP is in a sense more ‘futureproof’ than FTTC, with very low cost upgrades required for higher speeds, balanced by a much higher initial cost, and a much more disruptive installation process. At some stage a tipping point may be reached, but for now the FTTC/G.fast route is much the most economically compelling, and this is true regardless of how independent Openreach is.”

66. It is true that suppliers in a number of other countries have put more emphasis on FTTP than BT has in the UK. The reasons for this are many and varied, as described in two independent reports which Ofcom published alongside the Discussion Document. Neither Analysys Mason nor WIK suggest that the UK market has displayed any unexpected outcomes, or that any kind of market failure has resulted in sub-optimal outcomes. For example:
- Analysys Mason make clear that differences between countries “constrains our ability to draw general conclusions independent of country-specific factors”¹³⁴. That is, it is generally not possible to read across from what has been successful in one country to what will also be effective in another. They mention as the relevant “prevailing conditions” the existing PSTN architecture (including existence of cabinets, typical lengths of copper loops from the cabinet to the end user, and availability and quality of ducts), the geographic nature of competition (cable coverage) and housing density.¹³⁵
 - WIK concluded that “the main factor which has driven next generation access (NGA) deployment is infrastructure competition – primarily from cable, and in some cases from independent FTTH investors.”¹³⁶ They note that, “We find that cost factors such as the technologies deployed (FTTC vs FTTB vs FTTH2) and density of housing may also have affected NGA coverage.”
 - They also comment that “When technological choices are left to the market, we commonly see NGA deployment strategies which aim at

¹³⁴ Final report for Ofcom, International case studies, Analysys Mason 10 July 2015, Executive Summary, page 1

¹³⁵ Page 1, Executive Summary, Analysys Mason 2016 report

¹³⁶ All WIK quotes from “Competition & Investment: an analysis of the drivers of superfast broadband”, WIK, Summary of Findings, July 2015.

cost-efficiency such as FTTC or a mix of FTTx technologies depending on geography. This strategy may support more widespread NGA deployment. On the other hand, when regulators have specifically sought to promote technologies such as FTTH, and designed regulation to achieve this, there has been some FTTH deployment in the market – at least for a portion of the territory. However, these deployments may imply higher costs, which may not necessarily be matched by demand. For example, broadband usage is relatively low in several countries with FTTH networks including France and Japan.” In other words, as technological choices have been left to the market in the UK, the selection of lower cost FTTC deployment is to be expected, and this has been good for NGA coverage (a wide coverage has been achieved relatively quickly) and therefore good for final consumers.

- WIK add that, *“our assessment is that the UK (and much of Europe) are not ‘falling behind’ North America. Meanwhile, the world-leading outcomes in Korea and Japan may stem from Government programmes and incentives for fibre which were introduced in the 1990s.”*

67. BT provided a summary of the position in its response to Ofcom’s Discussion Document setting out, in particular, the major drivers behind FTTP which are absent in the UK:

- The UK has had a commercial-led policy, whereas some of the countries with high FTTP coverage have had a government-led, and heavily subsidised deployment (Australia, New Zealand and Singapore);
- Deployment costs for FTTP in the UK are relatively high because of the low proportion of households residing in Multi-Dwelling Units / Multi-Occupancy Units (unlike Singapore, Spain, Sweden and Portugal) and high labour costs relative to some EU Member States. For example, whilst 2/3rd of the housing stock in Spain is in Multi-Dwelling Units (MDUs), the comparable proportion in the UK is around 1/6th.¹³⁷ The UK has amongst the lowest proportion of households living in MDUs across the EU;
- UK customers may not have a high willingness-to-pay. For example, in Sweden the one-off costs for an FTTP connection is around £2,000 unless the property is in a MDU.¹³⁸ Customers in the UK typically pay

¹³⁷ These differences have a large impact on FTTP costs as blocks of flats can spread deployment costs (in particular, civil engineering costs) across the number of households served – such cost saving is not possible for 85% of households in the UK, against 33% in Spain.

¹³⁸ Presentation, “TeliaSonera fiber roll-out in Sweden”, Ove Alm, Access Network Evolution, TeliaSonera Sweden, Broadband Stakeholder Group London 2016

no one-off costs for fibre broadband connections (and often benefit from long periods of discounted rental);

- In Japan, tax advantages were made available for FTTP deployment which also took place in a context of a high proportion of MDUs;
- The UK has a preponderance of short sub-loop lengths, making FTTC an effective broadband delivery technology. Countries like France which have longer copper loop lengths do not have the same ability to send faster speeds over their copper wires; and
- There has been a regulatory requirement on Openreach to wholesale an active product on an EoL basis, reducing incentives for infrastructure investment by competitors in order to self-supply fibre broadband (for example, as in Portugal and Spain which have not required access services to be supplied on regulated basis).

68. The UK is not unique in tending to use FTTC, which is the predominant technology in the majority of EU Member States.

Figure 3.4.2.3 – FTTC has been the predominant technology choice in the EU to date (countries in blue)



69. These factors need to be recognised by Ofcom as it develops its strategies towards FTTP.

70. Notwithstanding the points just made, BT is not of the view that FTTP has no future in the UK. On the contrary, BT is of the view that it already has an important place in network deployment. In its original plans for commercial fibre deployment, BT had expected FTTP to make up a significant proportion of the total (20-25%); and BT continues to investigate opportunities to improve the business case for FTTP deployment. BT is committed to deploying an FTTP network to 2m premises by 2020, with a particular focus on SMEs; and BT remains open to the possibility in future that the market may reach a tipping point towards FTTP as the independent Enders Analysis report suggests.
71. For a tipping point to be reached in favour of FTTP as the predominant technology in the UK, we believe the following developments would need to be evident in the UK market:
- a. Considerably lower cost of deployment per customer;
 - b. Considerably higher end-customer demand for speeds not achievable on more cost effective solutions; and
 - c. A higher willingness to pay for the incremental speeds, sufficient to meet the higher costs of deployment.
72. BT's FTTP network in Openreach is the largest in the UK at present, admittedly with only about 330k premises passed. Despite the protestations of other CPs that investment in FTTP is essential, BT's downstream operations are the only ones committed to reselling Openreach's FTTP product in volume. In our experience only around 10% of FTTP customers choose to buy a product that is faster than that available on FTTC networks, and they typically pay a price that is around 25% higher than an FTTC product. As FTTP costs over five times as much to deploy as FTTC, it is obviously challenging to make the business case pay in with only a small increment in revenues. Nonetheless, BT will fulfil its existing commitments and will continue to seek more FTTP opportunities.
73. Although its findings on this issue are far from clear, Ofcom appears to consider that widespread roll-out of FTTP would be a preferable market outcome to other technologies, and that its absence can be characterised as some kind of market failure. There is no evidence supplied in support of this. There is no suggestion that BT's choices in relation to FTTP investment have anything to do with its corporate governance or vertical integration. As set out in more detail below, Ofcom makes no suggestion that FTTP roll-out is linked to "strategic discrimination". Indeed, Ofcom appears to accept, quite properly, that its proposed separation model would not be appropriate for addressing any concerns regarding the delivery of FTTP.¹³⁹
74. Ofcom also overlooks the fact that there is no apparent or clearly foreseeable willingness of consumers (or CPs) to pay for, or contribute to, the significantly increased costs associated with the provision of FTTP based services. To the extent this emerges over time, Openreach has every incentive to respond in

¹³⁹ Para. 6.59, Initial Conclusions.

order to ensure that it remains competitive with Virgin Media and other infrastructure providers.

75. Equally, Ofcom does not challenge BT's explanations regarding the comparative costs, timescale or disruption caused by FTTP rollout compared to FTTC. As the Compass Lexecon report explains, there is no basis for assuming that the current levels of FTTP reflect anything other than legitimate commercial decisions.¹⁴⁰ As such, there is no basis for suggesting that the current balance of broadband provision within the UK reflects a competition problem or regulatory failure that justifies an exceptional regulatory response.
76. The right policy approach is that Ofcom should leave it to the market to determine the balance between FTTP and other technologies. Furthermore, the Shortall Review identifies that any backing given by Ofcom for a particular technological solution is not consistent with a policy of technological neutrality at the heart of regulatory best practice and the European Framework. Ofcom should use existing regulatory tools to deal with any barriers that create bottlenecks or impede deployment, to reduce the cost of deployment for example, for BT and others. Neither of these approaches is aided or even supported by the extreme interventions in relation to the governance of Openreach.

3.4.2.4 Service levels

77. Ofcom also highlights general areas of concern relating to BT's performance, including on *"quality of service, and on the level of investment in UK infrastructure in general, especially the rollout of fibre to the premises."*¹⁴¹ Ofcom has called for a "step change" in quality of service across the industry, and explains that:

*"We are setting tougher quality of service standards for Openreach; we will publish performance data for all operators; and ensure consumers and small businesses receive automatic compensation if things go wrong. In April, we introduced new service-quality standards for the bespoke broadband services used by larger businesses."*¹⁴²

78. This aspect of Ofcom's concerns falls clearly within the scope of existing SMP regulation, which is already being used and which can be reviewed, if necessary, in the light of changing circumstances, to address concerns over service delivery. As such, these issues are not relevant to the question of whether to impose mandatory functional separation pursuant to Article 13a and ss. 89A and B.

¹⁴⁰ Para. 1.5, Compass Lexecon Main Report.

¹⁴¹ Para. 3.15, July Consultation.

¹⁴² Para. 1.8, July Consultation.

79. On the substance, BT is committed to increasing service standards to meet ever rising customer expectations. Service standards have been improving, as set out below, but BT agrees that they need to improve further to meet the standards required by customers. Delivering customer service to meet customer needs is not simply an Openreach matter. It requires the commitment of all the market participants downstream of Openreach across the industry as a whole, with appropriate regulatory support from Ofcom.
80. BT welcomes the more balanced approach to regulation that Ofcom adopted for the first time in 2014, which recognised that customers do not just want ever cheaper broadband, they want better service from broadband suppliers. BT welcomes the extension of this approach to the Ethernet product set in 2016/17. Service regulation by way of SMP conditions (minimum service levels, or “MSLs”) is the obvious method for enforcing the standards required by Ofcom on markets where BT has SMP.

3.4.2.5 Improvements in service levels

81. Whilst BT acknowledges there is still more to do in terms of improving performance, a balanced review of Openreach’s service performance should acknowledge that:¹⁴³
- 84% of faults are being fixed within two working days;
 - 93% of new lines are being installed on time;
 - the average time to get an appointment for an engineer visit is now seven days; and
 - Openreach is on track to halve missed appointments from five percent to two and a half per cent by the end of March 2017.¹⁴⁴
82. The improvements have been achieved with the help of significant new investment in people, systems, tools, training and process changes. Openreach has hired more than 5,000 new engineers over the last three years, and is currently in the middle of a recruitment which will see 1,000 engineers and 250 apprentices joining the company by the end of March 2017¹⁴⁵. The business is investing 50 per cent more into proactive network maintenance,

¹⁴³ Figures from Press Release and KPIs published by Openreach on 18 July 2016 at <http://www.btplc.com/News/#/pressreleases/openreach-makes-strong-progress-on-customer-service-1483045>

¹⁴⁴ Further information in relation to service, and the steps that Openreach has taken, and is taking, to enhance service are set out in Annex B.

¹⁴⁵ See further Section B.6, Annex B. The Openreach Charter is available here: <http://www.btplc.com/Sharesandperformance/Presentations/Presentations/keycompanyannouncements/downloads/OpenreachCharter.pdf>

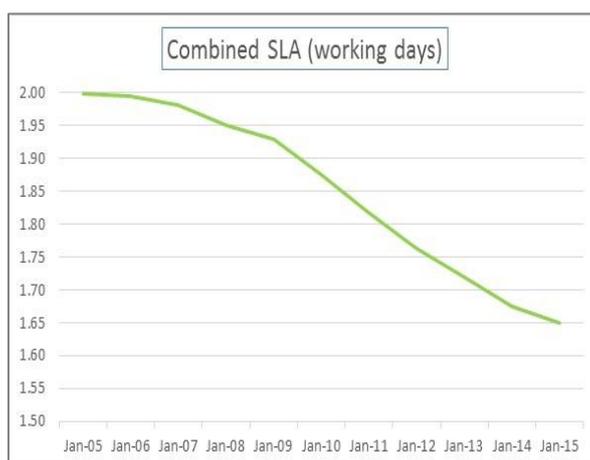
which is designed to identify vulnerabilities and prevent faults from occurring. More Openreach engineers¹⁴⁶ are being given training to widen their skills and reduce the reliance on specialists so that engineers will be able to complete a wider variety of jobs for customers in a single visit. Service improvements can also be seen in the reduction in the total number of complaints received by Openreach each week, as shown below.

Figure 3.4.2.5(i) – Openreach weekly complaints volumes since September 2014



83. It is important not to overlook the fact that average service levels in the copper broadband market have improved over the course of the last ten years, as volumes have migrated from WLR (with a 2-day repair time) to MPF (with a 1 day repair time). The chart below shows a 17% improvement in the number of working days before repairs are made by Openreach to the copper network between 2005 and 2015.

¹⁴⁶ 637 engineers were trained in underground works and 1,000 engineers were also upskilled to deliver new provision. This type of multiskilling is making a difference to both existing staff and new recruits, all of whom are trained to deliver both types of services. BT is also committing additional investment in this context

Figure 3.4.2.5(ii) – Openreach Repair SLA performance¹⁴⁷

84. Since Ofcom imposed Service Level targets, BT has met all its Minimum Standards, as set out below. Service level regulation under SMP conditions has been 100% successful and effective, requiring no other form of regulation instead or as well.
85. The requirements of the Minimum Standards for the two main narrowband access services (WLR Analogue and MPF) relate to ‘provision on-time’;¹⁴⁸ ‘first available date’ (FAD)¹⁴⁹; and ‘repair on-time’.¹⁵⁰ These targets are set by reference to 10 geographic regions within the UK,¹⁵¹ and the Minimum Standards are at the same level in each region. Compliance against these Minimum Standards is measured annually, with two of the three measures increasing over time as shown in the Figure below.

¹⁴⁷ See Annex B.

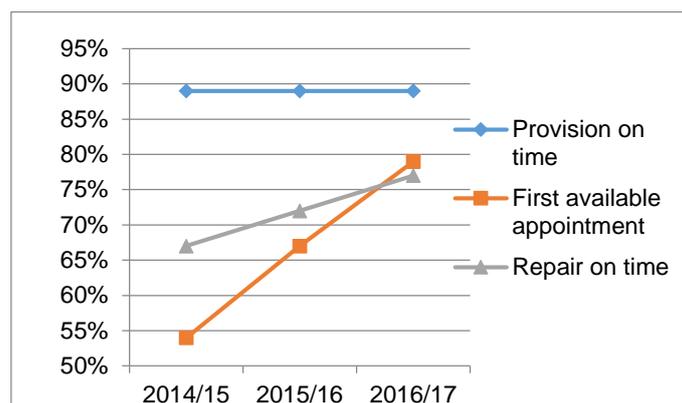
¹⁴⁸ Defined as the number of WLR and MPF provide orders that were delivered by midnight on the Customer Committed Date.

¹⁴⁹ Defined as the number of WLR and MPF ‘appointed’ (i.e. requiring an Openreach engineering visit to the end customer premises) provide orders where the first available appointment date was within 12 working days or less.

¹⁵⁰ Defined as the number of WLR and MPF faults that are successfully cleared within the Service Level Agreement of the relevant Service Management Level or customer agreed appointment, if an appointment exists.

¹⁵¹ There are therefore 60 Minimum Standards in each compliance year (2 products x 3 Minimum Standards x 10 geographic regions).

Figure 3.4.2.5(iii) – Minimum Standards for access products are increasing over time



86. The most recent compliance year ran from 1 April 2015 to 31 March 2016 over which Openreach was required to meet the Provision on-time Minimum Standard 89% of the time; the First available date Minimum Standard 67% of the time; and the repair on time Minimum Standard 72% of the time. As shown below, all these requirements were achieved for both products in all regions.

Figure 3.4.2.5(iv) – Openreach Performance against Minimum Service Standards in 2015/16

Region	Product	Provision on time – MSL 89%	First Available Date – MSL 67%	Repair on time – MSL 72%
		Performance %	Performance %	Performance %
Scotland	WLR	92.5	88.8	74.1
	MPF	92.8	92.5	76.8
North East	WLR	93.2	95.7	73.5
	MPF	93.1	96.4	74.5
North West	WLR	92.9	94.3	74.3
	MPF	93.3	95.9	74.5
NW and NM	WLR	92.9	90.5	74.1
	MPF	93.0	93.8	76.7
SW and SM	WLR	92.9	92.3	73.3
	MPF	93.1	94.0	73.5
Wessex	WLR	93.1	95.2	73.5
	MPF	92.9	96.6	75.1
South East	WLR	94.1	98.7	74.9
	MPF	94.4	99.2	75.8
London	WLR	93.5	99.2	82.6
	MPF	93.0	99.7	79.8
East Anglia	WLR	94.1	96.1	75.9
	MPF	93.9	96.9	77.4
Northern Ireland	WLR	93.2	98.5	86.8
	MPF	93.4	95.9	85.2
Summary		Met for both products in all regions	Met for both products in all regions	Met for both products in all regions

87. Despite significant improvements in recent performance, BT acknowledges that service standards have not always met customer requirements at times in the past. BT notes that there is inevitably a balance between reducing costs and improving performance. Some of the service issues at the Openreach level have arisen from the fact that Ofcom has implemented price controls whose effect has been consistently to force down the costs of Openreach access lines. In the last decade, Ofcom has taken £1 billion of profit out of Openreach (whose revenues are only £5bn a year). This approach has only once in 2014 balanced lower costs with an objective of promoting high service standards. BT welcomes this more recent approach from Ofcom which includes a cost allowance for meeting regulatory service standards (costs allowed to meet MSLs amount to about £25m), as one which balances the regulatory objective of lower prices with recognition that users also value improving service levels.
88. As has therefore been demonstrated in practice, Ofcom has the regulatory tools to intervene to improve service levels and is using them successfully. BT notes that Ofcom has not suggested that changes to Openreach's independence would have an impact on its approach to service regulation or that this is a basis for mandatory functional separation.
89. Indeed, BT notes that service regulation is still applied (and hence deemed to be needed) in the case of the structurally separated energy companies. As such, SMP regulation of services standards is, and would remain, the appropriate tools to address service issues whatever the functional or even structural changes might be made within BT. BT considers that this is the appropriate approach and that, so long as appropriate costs for delivering service improvement are allowed, they can reflect proportionate obligations on markets characterised by SMP. In summary, in relation to service related issues, the current regulatory framework does all that is necessary in this regard.
90. BT is aware that some stakeholders have alleged that BT itself benefits from poor service quality, i.e. that this is a form of "quasi-discrimination" in favour of BT. BT notes that Ofcom itself includes "*the potentially discriminatory effects of poor quality of service*" as one of the behavioural issues which does **not** support a case for changing the current model of separation, or which could be addressed, as appropriate, through its regular programme of telecoms market reviews.¹⁵² Accordingly, BT agrees with Ofcom that this is a matter best left in the first place to market forces, supplemented, if necessary, by safeguard SMP quality of service based regulation.

¹⁵² Para. 6.12, Initial Conclusions.

3.5 Ofcom's theory of harm is wrong and unfounded

91. Ofcom's rationale for intervention in the form of extreme functional separation is predicated almost entirely on its theory of harm, based on the perceived risk of BT/Openreach having an incentive to engage in strategic discrimination. It is noteworthy that Ofcom does not articulate exactly what is meant by "strategic discrimination" nor does it provide any meaningful analysis of the alleged ability and incentive of BT to discriminate.¹⁵³

3.5.1 Overview of Ofcom's theory of harm

92. Ofcom accepts that the existing functional separation and EoI regime have "*achieved good outcomes*¹⁵⁴" and "*market successes*"¹⁵⁵ in terms of preventing discriminatory wholesale access to inputs. It acknowledges that the existing regime has "*broadly addressed*" the concerns relating to discrimination identified in 2005.¹⁵⁶

93. Instead, in the absence of any complaints, disputes or indeed evidence of **actual** discrimination in relation to wholesale access, Ofcom asserts that the Undertakings and the SMP regime have:

*"failed fully to achieve the market outcomes that we think they should. This is because the vertically-integrated structure of BT inherently affects the way in which BT makes significant decisions."*¹⁵⁷

[..]

*"It is clear that the combination of BT's market power and vertically-integrated structure means that BT **still has the incentive to discriminate against competing providers**. Our current approach limits its ability to act on this incentive to an extent, but the underlying incentive to discriminate is unchanged. Therefore competition concerns related to discrimination **may still remain**."*¹⁵⁸ (emphasis added)

94. Although this wording seems to recognise that this is a concern about potential rather than actual discrimination, Ofcom seeks to identify a "gap" which the existing structural and regulatory arrangements have not fully addressed. This gap arises, in Ofcom's view, because the SMP obligations and the

¹⁵³ Para. 4.19, Compass Lexecon Main Report.

¹⁵⁴ Para. 3.12, July Consultation. Similarly, other CPs have noted that, on a day-to-day basis, BT does supply EoI products in accordance with its obligations "Sky did acknowledge that there was no day-to-day discrimination by Openreach between service providers." Nomura, Quick Note - UK Telecom Regulation - The case for Openreach separation, October 02, 2015.

¹⁵⁵ Para. 6.47, Initial Conclusions.

¹⁵⁶ Para. 1.13, July Consultation.

¹⁵⁷ Para. 6.47, Initial Conclusions.

¹⁵⁸ Para 6.28, Initial Conclusions.

Undertakings apply to products and services that Openreach has launched in relevant markets and to product developments in those markets under SOR regulations and therefore apply only after Openreach has invested in the network. They do not, Ofcom suggests, control the ability of BT to discriminate when making key strategic and investment decisions that shape the network itself in future.¹⁵⁹

95. Ofcom asserts that “*the underlying incentive for BT to discriminate against its competitors remains*” and that “[g]oing forward...BT can act on this incentive through the way strategic decisions are made about new investments by Openreach.”¹⁶⁰ The ability to act in this way stems from “*the control retained by BT Group over Openreach’s strategic decision-making and over specific decisions on the budget that is spent on the parts of the network used by competitors*”.¹⁶¹

96. As a consequence, Ofcom identifies potential risks to competition and investment:

“If Openreach is not responsive to the needs of all its customers, this could create risks to competition and investment, and ultimately the service received by UK consumers and business. Without a level playing field between BT and its competitors, consumers and businesses are less likely to see the benefits of competition, which include improvements to the price, choice and quality of communication services. Where major investments in the network favour the interests of BT Group, **there is a risk that these investments do not match to the needs of a wider group of UK consumers and businesses.”**¹⁶² (emphasis added).

97. It is clear that Ofcom sees these as *hypothetical* risks that might play out in the future:

- “**Where BT acts on this incentive**, other retail providers will be less able to deliver the innovation and services that their customers demand, unless this accords with the needs of BT Group. **Over time, this can reduce the range and choice of services available to end users, as well as risk slower introduction of new service launches.**” (para. 3.14)
- “**Looking ahead**, we are concerned that leaving the status quo **creates a risk** that investment and operational decisions lead to poor outcomes for UK consumers who rely on Openreach’s network.” (para. 3.16)
- “...**there could be** a particular network investment that is more favourable to BT’s retail competitors than its own divisions. Under the current structure, BT Group has an incentive, and importantly has the

¹⁵⁹ Para. 3.12, July Consultation.

¹⁶⁰ Para. 1.14, July Consultation.

¹⁶¹ Para. 2.6, July Consultation.

¹⁶² Para. 2.7, July Consultation.

ability, not to make that investment. This is regardless of whether it would be profitable for Openreach on a standalone basis or in the wider interests of consumers and businesses as a whole.” (para. 3.21)

- “*This governance structure means that **the way Openreach allocates its capital expenditure can be influenced** by the priorities of BT Group rather than the needs of all Openreach customers, particularly in relation to investments over £75 million. As a result, the interests of all customers **may not be** properly reflected in Openreach investment decisions. **This creates the risk** that such decisions are taken in a manner that gives preferential treatment to the interests of BT’s own downstream divisions over its competitors, to the detriment of consumers and businesses that rely on services delivered over the Openreach network” (para. 3.24, emphasis added).*

98. Ofcom does not, however, suggest that BT **has already, in actual fact, acted** on the alleged incentive to discriminate strategically in the decisions it has made to date which have shaped the network. Ofcom remarks that the current structure would or might allow BT to take a group perspective when considering decisions relating to Openreach, and cites the initial decisions by BT Group on rollout plans, levels of investment and network technology choice in relation to FTTC and G.Fast as examples. However, Ofcom **does not** argue that these investment decisions were in fact influenced by BT Group in such a way as to favour the interests of BT Consumer over the interest of other CPs, or that they were in any sense “*sub-optimal for the UK as a whole*”.¹⁶³

3.5.3 Deficiencies in Ofcom’s theory of harm

99. This key element in Ofcom’s theory of harm suffers from a number of fundamental flaws. As such, it does not form the basis for intervention under Article 13a or ss. 89A and B. In particular:
- a. Ofcom’s theory is not economically robust. It is based on assertion and supposition rather than compelling evidence or economic analysis;
 - b. There are logical gaps and omissions which undermine Ofcom’s theory, including:
 - i. Ofcom overlooks the relevance of network competition in assessing BT’s incentives; and
 - ii. Ofcom overlooks the importance of undifferentiated demand; and
 - c. Even if, contrary to the evidence, Ofcom had demonstrated that BT has an economic incentive to discriminate against its downstream competitors in its network investment decisions, Ofcom has not

¹⁶³ Para. 6.34, Initial Conclusions.

assessed whether the Undertakings or the existing SMP regime have prevented and will in the future be capable of preventing BT/Openreach from acting on it.

3.5.3.1 Absence of economic evidence or analysis

100. Ofcom's theory of harm is that "BT's market power and vertically-integrated structure means that BT still has *the incentive to discriminate against competing providers*". This sweeping generalisation is inconsistent with Ofcom's own market assessment and unsupported by evidence or analysis.

101. As set out in the Compass Lexecon Report¹⁶⁴, Ofcom's concerns are "*implausible from an economic perspective*"¹⁶⁵ and do not, therefore, justify the imposition of its Proposals. Compass Lexecon make the following observations in this regard:

*"Ofcom does not provide any meaningful analysis of this ability or incentive; does not identify any specific past or possible future instances of its strategic discrimination concern; does not provide any evidence that downstream market outcomes reflect, or are even suggestive of, such strategic discrimination; and does not explain why strategic discrimination may be a greater risk in the future than in the past."*¹⁶⁶

102. Compass Lexecon also identify that prima facie indicators undermine Ofcom's concerns (as discussed further below) and on the basis of this and the lack of evidence presented by Ofcom, it concludes that¹⁶⁷ "*Ofcom presents no evidence for its concerns and ignores prima facie reasons to doubt Ofcom's concerns*"¹⁶⁸. Ofcom's strategic discrimination concern is presented as a hypothetical risk which may arise in the future. As such, it is unproven and speculative without reference to past or future examples of such conduct, or a credible explanation of why such conduct may be more likely going forward.

3.5.3.2 No direct evidence

103. Ofcom has not identified any past or previous examples of BT having made investment and/or portfolio decisions which involved strategic discrimination.¹⁶⁹ It is impossible for BT to respond to such wholly unspecific allegations and concerns.

104. Nonetheless, given the emphasis placed by the CPs on the issue of network investment to facilitate superfast broadband, BT explains below how it has addressed recent decisions in relation to BT's technology choices or FTTP

¹⁶⁴ Section 4, Compass Lexecon Main Report.

¹⁶⁵ Ibid, para 4.3.

¹⁶⁶ Para. 4.7, Compass Lexecon Main Report.

¹⁶⁷ Para 4.18 et seq., Compass Lexecon Main Report.

¹⁶⁸ Para 4.50, Compass Lexecon Main Report.

¹⁶⁹ Para. 4.7, Compass Lexecon Main Report.

outcomes in the UK, confirming that there is no evidential basis for this aspect of Ofcom's theory of harm.

[BT's technology choices – 1\) FTTC outcomes provide no evidence of strategic discrimination](#)

105. Ofcom does not claim that BT's decision in 2008 to invest in a fibre access network, largely based on FTTC technologies (a decision which shaped the network), is an example of strategic discrimination.¹⁷⁰
106. Ofcom is right to have avoided any such allegation. In fact, there are clear and objective drivers for this decision, demonstrating that it was not influenced by a desire to favour BT's downstream businesses:
- *The key driver for investment was the need to meet rising end-user demand.* BT identified that end-customers' requirements had been rapidly increasing, and that they were out-growing the capabilities of the copper broadband network. It followed that, going forward, the Openreach network would need to upgrade its network to meet that demand. Furthermore BT saw the risk that it would struggle to compete with Virgin Media, and potentially 4G mobile networks, all of whom were engaged in network upgrades, if it did not invest in a fibre network capable of comparable speeds. As noted by Ofcom, "it has historically been competition from cable that has played a greater part in driving network upgrades ...BT announced its rollout of superfast broadband shortly after Virgin Media's upgrade to DOCSIS 3.0."¹⁷¹
 - *The initial business plans did not anticipate the investment providing any advantage to BT.* BT expected that all CPs would want to buy the fibre network products from Openreach. It was assumed that volumes on the fibre network would mirror those in the broadband market as a whole, with BT achieving a share of about 30%, with other CPs making up the rest.
 - *The investment has been successful.* The UK has achieved a strong position in international benchmarks for average speed and coverage of superfast broadband (as discussed above). Ongoing technical improvements continue to increase the achievable speed and performance since launch. Now that the value of FTTC investment has been proven, other CPs have taken advantage of the situation and are transferring their customer base to superfast services offered by Openreach.

¹⁷⁰ At para. 6.32 of its Initial Conclusions,, Ofcom refers to a submission by Vodafone that BT decided to invest in FTTC with "*limited discussion with its customers*" that focused on the implementation of regulatory obligations rather than the merits of the strategic decision to deploy FTTC itself.

¹⁷¹ Para. 4.11, Initial Conclusions.

107. There is no evidence, therefore, that BT's investment in a fibre access network, largely based on FTTC technologies, reflected anything other than the pursuit of legitimate strategic goals to meet the needs of end users by growing the capabilities of the network, and to remain competitive with Virgin Media.
108. In fact, this was an investment, for the benefit of consumers and competitors, that was undoubtedly facilitated by the fact of BT's vertical integration. It was possible to make a commercial case for this investment despite demand uncertainty and the unwillingness of CPs to pre-commit volumes because of the risk mitigation provided by BT's vertical structure as discussed further below:
- *In committing to this major programme of investment, BT's retail operations acted as an anchor tenant mitigating ex-ante the significant risk associated with the investment.* The risks arose from (i) the size of the investment £1.5bn in 2008, rising to £2.5bn in 2010, in the context of highly uncertainty demand for fibre; and (ii) the unwillingness of CPs to make any commitments to purchase new access inputs (indeed to deny that there was any market need for the product) and support the economic case for the investment programme. Other major CPs have publically acknowledged they adopted a "wait and see" attitude whilst BT forged ahead. For example, Jeremy Darroch, BSkyB CEO, said in November 2010 that: "*If there is demand for fibre from our customers, we will look to provide that but we are not going to rush into that until we see real levels of customer demand that are attractive.*"¹⁷² As recently as May 2014, Dido Harding TTG CEO commented that: "*...fibre is a premium product that really is only appealing to customers who've got poor broadband speeds.*"¹⁷³
 - *BT's retail operations then made good its risk mitigation role ex-post, by increasing its commitment as demand from other CPs did not fulfil expectations.* The risks of making the market in fibre broadband were effectively left to BT's retail operations as its competitor CPs chose not to sell fibre broadband in significant volumes until around three years after BT had launched. BT's own retail operations increased its commitment to market fibre broadband propositions and made up the shortfall in expected volumes needed to underpin the investment case. The case became dependent on the sales made by downstream BT as the anchor tenant, until third party CP demand began in significant volume once the market had been made. [✂

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[✂

¹⁷² Financial Times, November 17, 2010.

¹⁷³ TalkTalk Telecom Group PLC Earnings Conference Call, May 15 2014.

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109. As a factual matter, the FTTC investment case relied on end-to-end BT margins in order to achieve an acceptable commercial pay-back. The BT Group end-to-end case showed a 12 year pay-back, a long pay-back period by most commercial standards. At the Openreach level, however, the case showed a 19 year pay-back, an unacceptably long pay-back period for a commercial entity. This is because, although 95% of the capital investment involved with the fibre broadband case was investment at the Openreach level, only [X] of the profitability arose at the Openreach level. The other [X] of profitability was earned by BT's downstream retailing operations (and of course similar downstream profits would have been made by external CPs). Further, but for the benefits of having a committed retail reseller in BT Group, pay back would have been longer. Analysis by BT demonstrates that if BT's retail arm had sold fibre volumes at the same rate as did Sky, the payback (in terms of discounted cumulative cash flow) for the capital investment in the new fibre network would have stretched even further into the future, by about [X] years.
110. Ofcom has recognised that separation might mean that investment by Openreach could be lower than it would be under integration, and that – in any event – there is no guarantee that investment will necessarily increase.
- *“A structurally separate Openreach may also not face greater incentives to invest in new networks.”¹⁷⁴*
 - *“I think it is very difficult to be certain [about investment outcomes]. There are reasons potentially for believing that is the case [with full structural separation Openreach would invest more in the network than BT does through Openreach today] because the driver of doing it would*

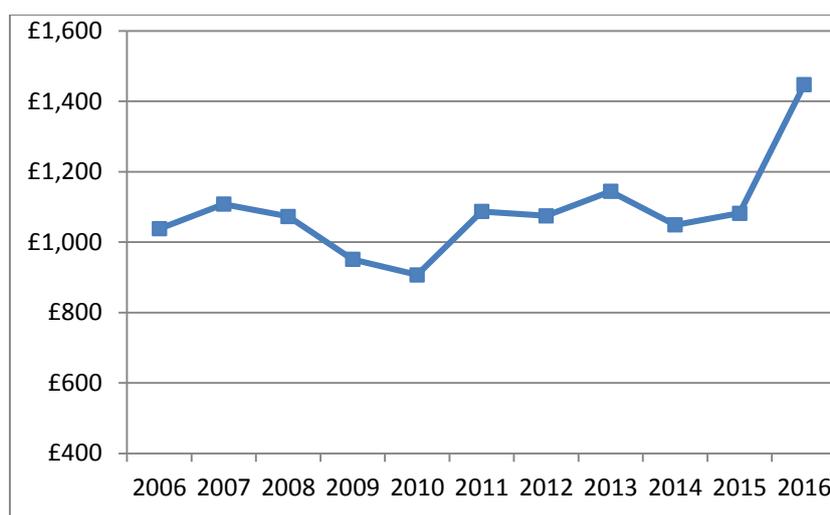
¹⁷⁴ Para. 1.44, Initial Conclusions.

*be that you are more responsive to all your consumers, possibly co-funding joint ventures and so on, but I cannot be definite that that will be the case.”*¹⁷⁵

The possibility that alternative forms of investment will emerge is discussed in Annex A.

Openreach investment since 2006 has totalled just under £12bn over the last 11 years and, as shown in Figure 3.5.3.2(ii) below, has been on an upward trend since 2010 as investment in the fibre programme began to ramp up.

Figure 3.5.3.2(ii) – BT’s investment in Openreach since 2006, £m



Source: BT Annual Reports

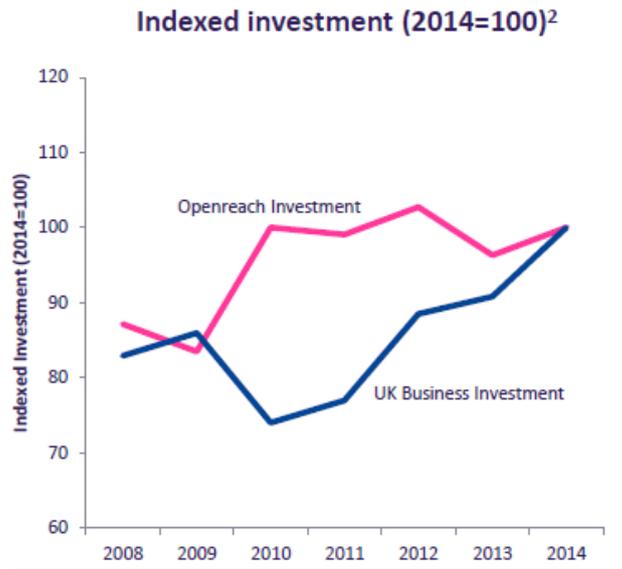
In the six years from 2011/12 to 2016/17, total gross investment (including the cost of building labour capacity to deliver the networks) will exceed £8bn. The trend has been on upwards trend - for 2016/17, gross investment is projected to be [£8.5bn], an increase of over [50%] on the level in 2011/12. Adjusting for efficiency in line with Ofcom assumptions used in setting prices (at 5% pa), gross investment will nearly have doubled over the period.

Evidence also shows that Openreach’s capex is high relative to that made by other European incumbents, as set out in the BT Response of October 2015¹⁷⁶. Openreach investment, particularly in its new fibre network, also took place when business sentiment was very weak and overall investment in the UK was falling.

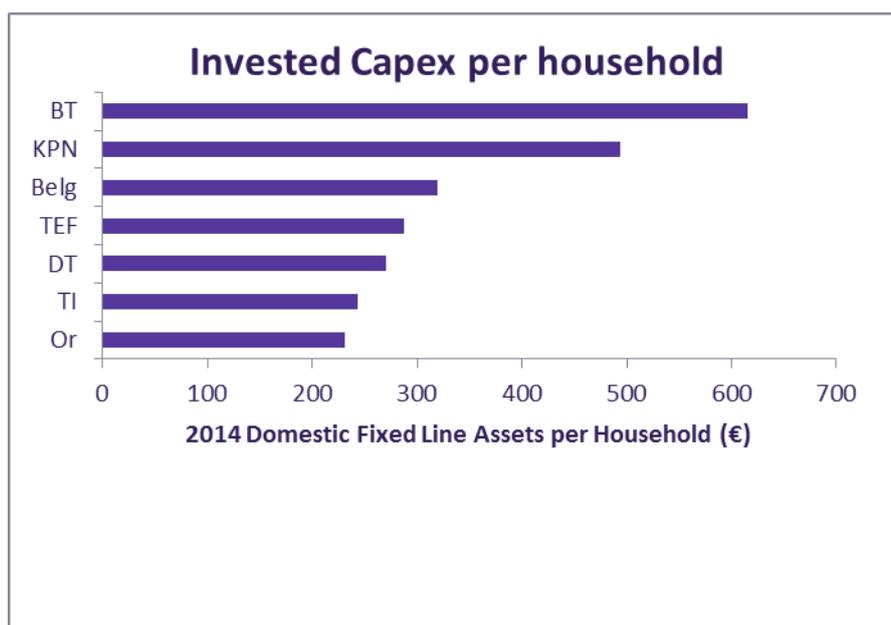
¹⁷⁵ Sharon White, CEO Ofcom, evidence to CMS Select Committee 12 April 2016 [Responding to Damian Collins on whether with full structural separation Openreach would invest more in the network than BT does through Openreach today].

¹⁷⁶ Para. 57, BT’s response to Ofcom’s discussion document “Strategic Review of Digital Communications” 8 October 2015.

Figure 3.5.3.2(iii) - Indexed investment: Openreach compared to UK Business Total



External benchmarking data provided to Ofcom by Nomura (not provided for BT, but for Nomura clients) shows that invested capital per premises in BT is greater than all comparators in their survey:

Figure 3.5.3.2(iv) – Invested Capex per household by CP

[BT's technology choices – 2\) FTTP outcomes provide no evidence of strategic discrimination](#)

111. As discussed at para. 64 *et seq*, above, there were objective factors supporting the choice of FTTC over other technologies.¹⁷⁷ There is no challenge by Ofcom to BT's position that FTTP outcomes in the UK reflect rational commercial choices at the time driven by network economics and the regulatory environment.
112. BT recognises that Ofcom states: *"Our ambition is to maximise the reach of new network investment... A good outcome in the long term would be to achieve network competition [with three or more operators] of around 40% of households."*¹⁷⁸
113. Whether or not this ambition is realised will very much depend on the commercial evaluations by those suppliers which may be considering widespread FTTP deployment and, as the Analysys Mason 2016 report describes, this will depend on the anticipated volumes to be achieved, as well as investors' appetite for risk. What is clear is that there are significant *existing* plans for infrastructure investment by suppliers already in the market, using a range of technologies to compete with Openreach. Infrastructure competition is not therefore dependent on new suppliers entering the market, or the specific use of FTTP.
114. Ofcom makes clear, however, that its ambition is that more homes and businesses will have FTTP (para. 1.16) as well as that, *"Our proposal [for*

¹⁷⁷ BT operates the largest FTTP network in the UK, albeit with only 330k premises passed, which is small compared to the 25m premises passed by our FTTC network.

¹⁷⁸ Para. 4.32, Initial Conclusions.

strengthened functional separation] *will combine with our wider DCR actions to bring about a step change in quality of service and an increased number of competing fibre networks.*” Ofcom further states that, its “*ambition is to maximise the reach of new network investment... A good outcome in the long term would be to achieve network competition [with three or more operators] of around 40% of households.*”¹⁷⁹. As pointed out in the Compass Lexecon report, “*Ofcom appears simply to assume that widespread provision of FTTP would be a preferable market outcome, such that anything falling short of this must, axiomatically, amount to a market failure. Ofcom has not presented any analysis to show that accelerated roll-out of FTTP would represent a preferable market outcome in the UK, in the light of the costs, benefits and timescale of such an investment, relative to alternatives including G.Fast (or even FTTC).*”¹⁸⁰

115. The evidence from European comparisons, provided by the Analysys Mason 2016 report, shows that there is no country in Europe that has 4 competing parallel fixed networks covering 40% of the country. There is no basis for believing that this would be an efficient market outcome. There are only 3 countries in Europe that have 3 parallel fixed networks covering 40% of the country, Spain, Portugal and Sweden. As explained above, these market structures are the result of the particular conditions of those countries, particularly the much higher proportion of consumers living in multi-dwelling units, and the lack of active wholesale access, which do not apply in the UK. There is no basis for believing that three parallel networks is a likely or efficient outcome in the UK.
116. Even if Ofcom had provided a cogent justification for its aspirations in relation to FTTP (which it has not), there is no explanation of how FTTP market outcomes may be expected to be different under different structural and governance arrangements as the relationship between the two is not specified. Nor is there any explanation of why Ofcom needs to go beyond SMP remedies in pursuing this objective, coupled with the impact of the Cost Reduction Directive. It is unsurprising, in this context, that Ofcom makes no explicit allegation that FTTP market outcomes are influenced by strategic discrimination.

[BT’s technology choices – 3\) Investment decisions in the pipeline likewise provide no evidence of strategic discrimination – G.Fast](#)

117. As regards investments in the pipeline, Ofcom also refrains from citing BT’s proposed investment in G.Fast as evidence of its strategic discrimination concern. Again, there is no evidence to support any such allegation.
- Firstly, this proposal has again been driven by (a) recognition of the need to meet rising consumer demands; and (b) competition from network rivals who also recognise the need to enhance their networks and who are doing so (for example, the upgrade in the maximum speed

¹⁷⁹ Para. 4.32, Initial Conclusions.

¹⁸⁰ Para. 4.14, Compass Lexecon Main Report.

offered by Virgin Media to 200Mbit/s¹⁸¹) not by incentives to discriminate.

- Secondly, Ofcom would be unable to explain how discrimination in favour of BT's retail operations could realistically occur if BT did invest in G.Fast because the technology would become available on an equal access basis and CPs would have significant advance notice allowing them, if necessary, to adapt to gain maximum value from BT's investment.
- Thirdly, whilst it recognises the need to take action to meet rising consumer demands, BT has not in fact made a decision to proceed with its G.Fast investment, as the case has not yet gained authorisation from the BT Board.

118. Ofcom does, however, refer to inadequate customer consultation in relation to BT's *"initial strategic decision to invest in ultrafast broadband and to adopt a particular technology"* (i.e. G.Fast). This assertion is factually incorrect as BT has engaged with stakeholders substantially and meaningfully as set out in Annex C.¹⁸² But in any event, discrimination in investment choices cannot be inferred from an alleged lack of customer consultation.
119. More generally, Ofcom does not identify any discriminatory concerns in relation to the SOR process. BT has, at all times, been open to proposals brought by customers through this process including in relation to investment choices. The absence of any such proposals does not demonstrate the failure of the regime. It can be explained by a lack of commercial incentive for retail competitors to propose investments other than those chosen by BT; that is not evidence of strategic discrimination by BT but rather of its customers pursuing their own commercial objectives.
120. Ofcom has not at any point found that BT has unjustifiably rejected a request from a CP pursuant to the Statement of Requirement regime in the Undertakings. Indeed, in the Initial Conclusions, Ofcom stated that it had not *"found any significant differences in acceptance rates or completion times between new products requested by BT's retail businesses and those requested by its competitors"*¹⁸³.

¹⁸¹ An additional factor here, as elsewhere, is pressure from Ofcom and the government to upgrade broadband speeds throughout the country, as a form of enhanced USO.

¹⁸² Annex C describes the consultation undertaken by Openreach with customers at all levels, i.e. from the high level CEO to CEO meetings, to consultation and industry fora that relate to both operational and commercial issues. In particular Openreach runs or actively participates in a wide variety of industry fora, most of which meet monthly, where requirements and plans are discussed with CPs. Further, Openreach is highly proactive and transparent in dealing with its customers on an industry level, including frequent communication from senior Openreach management. It also provides details in relation to the consultations concerning Openreach's G.Fast proposals.

¹⁸³ Para. 6.48, Initial Conclusions.

121. Given the lack of historic examples, there is no evidential or economic basis for Ofcom's assertions regarding hypothetical risks in future.

3.5.3.3 No indirect evidence

122. Similarly, Ofcom cannot point to any indirect evidence of strategic discrimination, indicating a causal effect on market outcomes. As set out above, outcomes in the retail market have been positive for users, with Ofcom recognising that BT's competitors have achieved comparable retail scale to that of BT itself.¹⁸⁴ Compass Lexecon comment in this regard, "*as well as not providing examples of past strategic discrimination occurring upstream, Ofcom has not provided any evidence of a causal effect between its concerns and any past or current detrimental effects on market outcomes. Indeed the evidence indicates that vigorous competition has emerged in retail markets as CPs have successfully contested market share in competition with BT using Openreach's access products.*"¹⁸⁵

3.5.3.4 There are logical gaps and omissions which undermine Ofcom's theory

123. Consistently with economic theory and the statutory scheme, any theory of harm based on incentives to discriminate would need to be analysed within a robust economic framework, supported by analysis and evidence of persisting competitive problems or market failure. In particular, it is necessary to assess the facts of the case, because any possible benefits of discrimination to BT at the downstream level might be outweighed by the negative impacts for other parts of the Group.¹⁸⁶
124. Ofcom has found that BT does not always have an incentive to discriminate. For example, Ofcom's analysis of Ethernet markets for mobile backhaul has indicated that BT does not have market power and does not have the incentive to discriminate. When the CMA considered the effects of the BT/EE transaction on mobile backhaul markets it used vertical arithmetic and found that a combined BT/EE would not have the ability and/or incentive to disadvantage competitors such that there would be significant harm to competition.
125. Ofcom has sought to avoid the requirement to perform market specific analysis of BT's incentives by framing its concerns in terms of strategic decisions rather than actual discrimination in relation to wholesale access to specific products and services. As clarified above, Ofcom does not consider that there is any issue with wholesale access as the EoI obligations in the Undertakings have been effective. However, even in a case of forward-looking strategic decision-making, Ofcom is still required to specify, by reference to economic analysis, what is driving these strategic incentives and how discrimination would be value creating for BT. As explained below, Ofcom has not specified any such

¹⁸⁴ Para. 1.13, July Consultation.

¹⁸⁵ Para. 4.11, Compass Lexecon Main Report.

¹⁸⁶ A key tool used by competition authorities and other regulators in this regard is vertical arithmetic which allows detailed consideration of the relative upstream and downstream gains from any suspected discrimination to the accused entity in a position of market power.

mechanism nor undertaken any analysis of this nature. The sections below explain why strategic discrimination is unlikely to be value generative given the constraints that BT faces from other network providers, and the fact that all CPs buy broadly the same kinds of products from Openreach and serve the same end-users.

126. Ofcom's hypothesis is that, under the current governance arrangements, there might be network investment which would serve the interests of consumers and businesses "as a whole", and be profitable for Openreach, which would not be undertaken by Openreach because it would benefit BT's retail rivals more than BT's retail operations.
127. In short, Ofcom is relying on a theoretical argument that alternative investment choices might be made under different arrangements if Openreach were more responsive to the wider needs of consumers and business.¹⁸⁷ Ofcom advances no evidence that this is, or is likely to be, the case, or that any investment decision has or has not in fact been made on this basis.
128. Aside from being unevidenced, Ofcom's hypothesis is fundamentally flawed for a number of reasons:
- BT Group, as is typical of commercial businesses, seeks sustainable, profitable revenue growth by satisfying customer needs, both end-customers in the market and its immediate CP customers, within regulatory constraints;
 - BT has an incentive to undertake network investment which will grow the capabilities of the network, both in the interests of consumers, businesses and other network operators that use its services, and who have ever-rising demands, and so that it is better able to compete with network competition, particularly from the cable operator and to some extent from mobile network operators;
 - Ofcom has mandated equal access to all of Openreach's infrastructure through the EoI regime in the Undertakings. This makes discrimination impossible and there is no evidence of complaints or disputes regarding alleged discrimination, even in markets which are not subject to the EoI regime;
 - The prospect of discrimination would only arise hypothetically where BT's downstream operations valued a network investment that was not valued by other CPs. However, that scenario does not arise in a market where there is effective retail competition as there is commonality of interests between BT and CPs in serving the same end-users and

¹⁸⁷ Para. 6.66, Initial Conclusions.

hence an alignment of interests regarding the network investments needed to compete effectively; and

- Ofcom does not give any instance¹⁸⁸ or even explain how a case for investment might theoretically be made by CPs which could not be made by BT because of differentiated demand (i.e. because it would enable CPs to deliver the innovation and services **their** consumers demand but which are not wanted by customers of BT Consumer). There is no reason to think that this might be the case. BT Consumer is competing for the same consumers as other CPs, and if there is demand for innovation and services which justifies strategic investment, BT will make the investment. Equally, there can be no suggestion that BT might pursue an inferior network strategy because it would have more to lose from a strategy which stimulated more competition. Such a strategy is implausible given BT's reduced market share in retail markets and the risk of conceding competitive advantage to other network providers with adverse consequences for BT both at the wholesale and retail levels of the market.

[Ofcom overlooks the relevance of network competition in assessing BT's incentives](#)

129. As stated in Section 3.2.3 above, BT faces network competition from rival infrastructure providers, in particular Virgin Media and others including 4G networks, which influences its incentives in relation to strategic investments which “*shape the network itself*”.
130. In its Initial Conclusions document, Ofcom makes clear the significance of competition as opposed to structure and governance arrangements in driving incentives to invest. It states, “*Openreach's incentives to operate efficiently, invest or deliver a good quality of service*” may be “*dampened by a lack of sufficient competition at the infrastructure level, and **not because BT is vertically integrated***”¹⁸⁹ (emphasis added). Consistent with this, Ofcom identifies in the July Consultation that, “[n]etwork competition is the most effective spur for continued investment in high quality, fibre-based networks”.¹⁹⁰ Ofcom appears, therefore, to confine its concerns to areas where network competition is not viable and where “*most consumers and businesses will continue to depend on service providers who purchase access to the Openreach network.*”¹⁹¹

¹⁸⁸ The challenge to BT to make additional investments in FTTP is not such a case – there is no reason to say that rival CPs would benefit from such an investment to a greater extent than BT's own retail arm or that BT has decided to invest in other technologies to benefit BT retail as against other CPs.

¹⁸⁹ Para. 6.59, Initial Conclusions.

¹⁹⁰ Para. 2.3, July Consultation.

¹⁹¹ Para. 2.4, July Consultation.

131. The Compass Lexecon report explains that network competition reduces BT's ability and incentive to engage in strategic discrimination, including in areas not covered by network competition.¹⁹² More specifically:

- The major investments which “shape the network itself” will be made in response to network competition; they are not confined to areas where BT faces competition as BT will implement its solutions more widely.¹⁹³ BT's strategic investments will be deployed both in the areas where BT faces direct network competition and in those areas where it does not. There are strong incentives to roll new technologies out widely in order to benefit from economies of scale and scope (given significant upfront development costs) and experience curves (i.e. lower costs from experience and knowhow). This also reflects the conditions of the retail market: it is typically not a sustainable strategy in the retail market for BT to offer superior products in only the competitive market areas and not more widely.¹⁹⁴ That is why BT's fibre broadband product was not only targeted at competitive areas, but was deployed in all areas where a sustainable economic case could be made.
- Greater network competition will diminish any incentive for BT to discriminate and may remove it altogether going forward.¹⁹⁵ Network competition must be assessed prospectively not statically.¹⁹⁶ As competitive areas expand (which is Ofcom's aspiration), the residual area, in which strategic discrimination could conceivably be engaged, will become progressively smaller over time.¹⁹⁷
- Where BT's strategic investment decisions are driven by network competition, they will represent BT's best strategic response to the challenge posed by rivals' networks – i.e. they will aim to provide the choice and service to downstream customers that will enable BT's retail operations to compete with retail competitors that use the rival network.
- The obligation to provide equal access ensures that the CPs who use Openreach share the benefits of this investment and are also in a position to compete effectively for customers with retail competitors that use the rival network, especially as they are protected by margin squeeze rules downstream. In short, there is no investment choices that

¹⁹² Paras. 4.23-4.28, Compass Lexecon Main Report.

¹⁹³ Paras. 4.24-4.25, Compass Lexecon Main Report.

¹⁹⁴ It is equally implausible that BT would make a country-wide technology choice based on the area of the country in which it does not face competition with adverse consequences for BT in the part of the country where it does, particularly where the expansion of network competitors will mean that the former will become a smaller proportion of the country over time. Para 4.26, Compass Lexecon Main Report.

¹⁹⁵ Para. 4.23, Compass Lexecon Main Report.

¹⁹⁶ Para 4.29, Compass Lexecon Main Report.

¹⁹⁷ Para 4.29, Compass Lexecon Main Report.

could be an optimal response by BT to network competition AND benefit BT's consumer business more than rival CPs.

- Equally, Openreach is incentivised by the same competitive pressures to adopt CP sponsored investment proposals which would place users of the Openreach network in the best position to compete with network rivals. As Compass Lexecon state “[w]here *Eol* means that no CP, including BT Retail, relying on Openreach access can expect to have first mover advantages, it remains the case that all these CPs have a common incentive to be as competitive as possible vis-à-vis other platforms.”¹⁹⁸ To the extent that the mechanisms by which Openreach may consider any such CP-led proposals are deemed to be imperfect, this can be resolved through process improvements.¹⁹⁹ Openreach can be expected, however, to respond positively to such proposals if they represent the best strategic response to network competition.
- Whilst the speed of roll out of a new technology choice may vary geographically, this is not a discrimination concern. As Compass Lexecon point out such rollout timing decision “*would not reflect strategic discrimination as it would not benefit BT relative to rivals also relying on Openreach*”.²⁰⁰
- Strategic investments in the pipeline will be influenced by the expected degree and nature of network competition going forward, in particular, the effect of UK and European regulation designed to promote greater competition, and the investment plans of large and well-funded rivals such as Virgin Media.

132. In short, BT's investment choices are currently driven by the desire to achieve sustainable profitable revenue growth and by the need to compete with rival networks. Investments in the pipeline will be influenced by the need to remain competitive as competition ramps up (in particular, as Virgin Media network coverage expands). Compass Lexecon concludes that Ofcom has not adequately addressed the relevance of network competition for BT's incentive to engage in strategic discrimination.²⁰¹

¹⁹⁸ Para. 4.28, Compass Lexecon Main Report.

¹⁹⁹ In this regard BT's Proposal includes a formal three-stage process for consultation on substantial investment decision. This would include a confidential stage during which Openreach can only share information with the BT Group CEO and BT Group CFO in very limited and strictly defined circumstances (as discussed further in Section 5.3.1).

²⁰⁰ Para. 4.27, Compass Lexecon Main Report.

²⁰¹ Para. 4.30, Compass Lexecon Main Report.

[Ofcom overlooks the importance of the commonality between BT Consumer and its rivals](#)

133. It is not the case that certain investment choices will better meet the needs of certain customers and businesses than others. The allegation that BT has an incentive to engage in strategic discrimination depends on there being:
- differentiated demand for innovation and services between the customers of CPs and the customers of BT;²⁰² and
 - investment choices which better meet the needs of certain customers and businesses than others, so that execution of such a strategy would deliver benefits to BT's downstream businesses over rival CPs.
134. Putting these hypotheses together, Ofcom concludes that “[w]here major investments in the network favour the interests of BT Group, there is a risk that these investments do not match to the needs of a wider group of UK consumers and businesses.” In other words, Ofcom alleges that BT may favour customer specific investments which will meet the needs of its own retail consumers, but not those of a potentially wider group of consumers and businesses.
135. This is another speculative suggestion that has no theoretical or evidential support and that therefore cannot provide a basis for exceptionally intrusive regulation. There is no identifiable or significant segment of the retail marketplace for fixed communications services that BT does not seek to serve and where it does not face full competition from other CPs using Openreach inputs. Put simply, the UK retail market is fully competitive and there is no mismatch in competitive activity that could give rise to divergent interests.
136. When making decisions that “shape the network”, BT has incentives to invest and innovate to ensure that the needs of consumers and businesses (both customers of BT and those of CPs) are met, given existing and prospective competition from Virgin Media and other competitors including 4G networks (as described above). In other words, if there is demand for innovation and services (or where this demand is expected to emerge over time) which justifies strategic investment, BT has incentives to make the investment in order to meet customer needs and to remain competitive (both in respect of BT's own customers that might be lost and those of CPs, whereby BT would lose retail and wholesale revenues respectively).
137. In making these decisions, BT cannot give competitive advantage to its downstream businesses because the Openreach inputs which are enabled through BT's strategic network investment have common and standard characteristics, based on the same technology and the same wholesale products.²⁰³ They are required to be made available on EoI terms such that

²⁰² Ofcom states in this regard, “Where BT acts on this incentive, other retail providers will be less able to deliver the innovation and services that their customers demand, unless this accords with the needs of BT Group.” Para. 3.14, July Consultation.

²⁰³ They provide connectivity to homes and businesses at different speeds.

BT's downstream business and rival CPs have an equal opportunity to commercialise these inputs in order to attract and retain customers.

Indeed the Undertakings require that the EoI wholesale product from Openreach must be available in the market before any BT retail product can be launched, removing even a reliable first mover advantage from BT. More specifically, the portfolio of products made available by Openreach (all on an EoI basis) allows retail rivals to contest different customer segments (i.e. those with different valuations for the retail products in question) allowing different commercialisation strategies to be pursued.

138. Moreover, as the Compass Lexecon report explains, even if some degree of adaptation is needed to allow rival CPs fully to commercialise Openreach inputs in competition with BT Consumer, there is a long lead time from inception to commercial deployment. For example, FTTP is estimated to take 20 years and G.Fast over 10 years. Those long time lags allows rival CPs to forecast and adapt.²⁰⁴ This aspect of the market also implies that it would be hard for BT to predict CP responses and commercialisation strategies in advance. The report states, *“even if Openreach’s strategic choices today were for investments that appeared more suited to BT’s downstream business than rival CPs, it is far from clear that BT would have any advantage when the investments are commercialised given the rapid rate of change in downstream markets.”*²⁰⁵ As a result, it is hard to see how any theoretical ability to discriminate translates into reality.
139. In summary, BT does not consider that the network inputs provided by Openreach can be configured through investment choices in a way that gives systematic advantage to BT’s downstream business over rival CPs. Not only is BT’s investment choice likely to be the best strategic response to competition for both BT and CPs, but BT and CPs have an equal opportunity to exploit the investment to deliver value to their respective consumers. Even if a degree of customer specificity did exist, it is very unlikely that BT could make investment choices that would reliably and significantly disadvantage rivals given the scope for adaptation in rapidly evolving downstream markets. That in itself makes it highly unlikely that BT would act on such a theoretical and speculative basis.

3.6 There is no element of exceptionality to justify Ofcom’s Proposals

140. Given the intrusive and costly nature of functional separation, the burden of proof rests on Ofcom to demonstrate the need for such intervention as an **“exceptional measure”**²⁰⁶. It is a **“measure of last resort”**²⁰⁷, that is only to be used when the wholesale obligations in Article 9 to 13 of the Access Directive

²⁰⁴ Footnote 96, Compass Lexecon Main Report.

²⁰⁵ Para. 4.39, Compass Lexecon Main Report.

²⁰⁶ BEREC Guidance, Page 8.

²⁰⁷ BEREC Guidance, page 9.

will not be sufficient to alleviate the competition problems in the market place and, by definition, functional separation is the “**sole remedy**” that can do so²⁰⁸.

141. For the reasons set out above, there has been no “stark” failure in regulated outcomes in the UK market. As the Shortall Review concludes, the indicators for the UK perform well above the EU average and, indeed, outperform most other EU markets.²⁰⁹ As such, he concludes that it would be an “oxymoron” for Ofcom’s Proposals to be considered justified on the basis that circumstances are “exceptional”. The result would be that, “*every other Member State could also justify using the exceptional remedy of functional separation since their performance is worse than that of the UK and therefore the exceptional would become the mundane*”.²¹⁰
142. Moreover, as noted above,²¹¹ Ofcom has failed to conduct the internal review mandated by BERC Guidance prior to the imposition of an extreme functional separation remedy. It has not, therefore, assessed the effectiveness and enforcement of standard SMP remedies – indeed, Ofcom has not even attempted recourse to such obligations, or ancillary measures such as internal procedures or KPIs. Nor has it collated a “substantial track record of enforcement activity” regarding instances of strategic discrimination. Ofcom has, therefore, failed to establish the requisite “exceptionality” for the imposition of further functional separation.

3.7 Conclusion

143. In summary, there are fundamental flaws in Ofcom’s reasoning which means that its hypothetical strategic discrimination concern is very unlikely: (i) to be relevant in reality; (ii) to be confirmed following a thorough market review; and (iii) to meet the relevant legal tests. Ofcom has not explained what it means by strategic discrimination, nor how it can arise in practice, nor how BT could profit it by it, nor how it would therefore be motivated to pursue it. It is presented purely as a hypothetical construct.
144. In particular, there is no consideration by Ofcom, of the following factors which make any such conduct very unlikely to be relevant in reality:
- the legitimate commercial objective of pursuing sustainable profitable revenue growth subject to regulatory constraints;
 - the role of network competition in driving BT to behave competitively in making investment choices including in those areas of the country where it faces less network competition; and

²⁰⁸ Ibid. See Also Regulation 61 of the Better Regulation Directive and Ofcom’s duties in Article 8(1) and 8(5) of the Framework Directive to adopt targeted, proportionate ex ante measures where there is no effective and sustainable competition.

²⁰⁹ Pages 14-16, Shortall Review. See also pages 3-7, Analysys Mason 2016 report.

²¹⁰ Ibid., page 17.

²¹¹ See paras. 51-53, Section 3.3 above.

- the absence of any possibility of strategic discrimination given that the products supplied by BT (to itself and CPs) are standard and shared on EoI terms.
145. Standing back, third parties have acknowledged that there has been no discrimination in any equal access market. Indeed, a Nomura note of 2 October 2015 stated that: *“Sky did acknowledge that there was no day-to-day discrimination by Openreach between service providers.”*²¹²
146. BT concludes that neither Ofcom nor other CPs has provided evidence to demonstrate that BT has engaged in any discriminatory practice prohibited by the Undertakings and SMP Framework over the ten years that the regulation has been in place. If there were important persistent competition problems, one would expect, in line with the BEREC Guidance, for there to be some track history of increasing disputes between BT and the other CPs regarding discriminatory practices and Ofcom’s unsuccessful attempts to enforce existing SMP BT’s obligations.²¹³ There is no such evidence.
147. From a regulatory perspective, this is not surprising, in that discrimination at the Openreach level is effectively impossible because of the EoI obligation in the Undertakings (and increasingly as a standard term in SMP regulation). As explained in the Annex D, BT’s compliance with the Undertakings has been extremely high, over 99.99%. Accordingly, there is simply no basis for any allegation that the Undertakings or the existing SMP regime have been inadequate to guarantee effective competition or to prevent the emergence of serious competition problems.
148. The position is in fact the opposite. The evidence is of competitive retail markets and increasingly effectively competitive access markets regulated by a comprehensive SMP regime that has been designed and enforced to ensure that no such competitive problems can emerge, complemented by the Undertakings (now to be replaced by a further voluntary updating and upgrading of those undertakings in terms of the BT Offer).
149. Ofcom has not provided any evidence to discharge its burden of proof by demonstrating that:
- Standard SMP remedies have failed to achieve effective competition. Ofcom has not demonstrated that the existing SMP regime and Undertakings have failed to deliver effective competition. In fact, where Ofcom does refer to levels of competition in specific markets, it highlights positive outcomes. It states, *“they [the Undertakings and EoI regime] have enabled BT’s competitors to achieve a retail scale comparable to BT itself. In 2005, BT’s competitors had a 2% share of broadband connections using local loop unbundling; that share has now increased to 40%. This increased level of competition has in turn*

²¹² Nomura, Quick Note - UK Telecom Regulation - The case for Openreach separation, October 02, 2015.

²¹³ BEREC Guidance, pages 13-14.

benefited consumers and businesses, broadband take-up having grown from 31% to 78%.”²¹⁴

- There are persisting competition problems and/or market failures. Ofcom’s concern about strategic discrimination is a hypothetical construct which has not been articulated or explained by reference to evidence of identifiable and causally linked competition problems or of market failures in specific markets or sectors of those markets. Ofcom does not substantiate its alleged “gap” in the current regime. In particular, it provides no past examples of strategic discrimination which the SMP obligations and Undertakings have failed to prevent. Moreover, although Ofcom makes clear that it wishes to see more network competition and better service levels, it provides no explanation of the contribution that strengthened functional separation will make to these goals as distinct from Ofcom’s other DCR actions which will be implemented through SMP remedies. In particular, Ofcom does not explain how strengthened functional separation will deliver “*a step change in quality of service and an increased number of competing fibre networks*” over and above Ofcom’s specific interventions in these areas through SMP remedies, in particular the proposal to reduce deployment costs by facilitating access to BT’s ducts and poles.
- There is little or no prospect of effective and sustainable infrastructure-based competition within a reasonable timeframe. On the contrary, as indicated above, a substantial and increasing proportion of the UK market is characterised by effective competition from Virgin Media as a vertically integrated competitor with exclusive access to an alternative network with significant advantages over BT’s network. Moreover, Ofcom **does** have an expectation that the degree of infrastructure-competition will increase going forward supported by additional SMP remedies. More generally, Ofcom has not explored how existing and prospective network competition acts to remove BT’s ability and incentive to engage in strategic discrimination, including in areas where BT faces less network competition.
- There is an exceptional need to intervene using functional separation as a measure of last resort. For all of the above reasons, the requirement of exceptionality is clearly not made out – on the contrary, as Mr Shortall emphasises, the position is again the opposite of exceptional – the UK is a dynamic and effectively competitive market. Far from there being an ‘exceptional’ need for such a remedy, the case for any such remedy being needed is, in reality, exceptionally weak.

150. As a result of its omissions and errors, Ofcom has not met any of the legal or evidential requirements imposed by Article 13A and ss. 89A and B as the jurisdictional threshold which must be satisfied before Ofcom can resort to regulatory intervention in the form of extreme functional separation.

²¹⁴ Para. 1.13, July Consultation.

SECTION 4 - OFCOM'S PROPOSED MODEL FOR THE GOVERNANCE OF OPENREACH

4.1 Introduction

1. In its July Consultation, Ofcom sets out its Preferred Model based on the full incorporation of Openreach by way of: (i) a specific autonomous governance of Openreach; and (ii) transfer of trade, employees, network assets, wayleaves and properties²¹⁵.
2. This section demonstrates that, in formulating its Proposals, Ofcom has failed to satisfy the legal, substantive and procedural requirements required by Article 13a, Article 8 of the Framework Directive and the principles of better regulation. In particular, it should be noted that Ofcom has failed to carry out any form of impact assessment or proportionality exercise, which are required as a matter of domestic and EU law, before it can justify recourse to such an extreme form of functional separation.
3. More specifically, the evidence in this section shows that Ofcom's Proposals would involve disproportionate costs and other harmful economic consequences, and would not be workable in practice. There are no identifiable benefits to weigh against what are substantial and verifiable economic and implementation costs, in particular, the loss of vertical coordination benefits resulting in less investment. Ofcom's Proposals are, therefore, not only ineffective as a remedy but harmful to the communications sector as a whole, with detrimental effects for investment, competition and consumers.
4. As we have noted, Ofcom itself has recognised that its Preferred Model could result in significant costs and has identified a number of areas where it acknowledges that a flexible approach should be taken, particularly if the costs associated with implementation are high. It has therefore indicated – at a level of generality - an Alternative Model in which BT would not be obliged to transfer to Openreach all assets, people, contracts and systems it currently has access to²¹⁶ in order to deliver its services. While it is unclear precisely what the elements of Ofcom's Alternative Model are and how they would operate in practice, BT and its advisers have also undertaken a high level assessment of the implementation costs of Ofcom's Alternative Model and have concluded that, even if all the mitigations are taken into account, the costs remain disproportionately high.
5. This remainder of this section sets out:
 - i. Ofcom's failure to satisfy its legal duties;

²¹⁵ Para. 5.33, July Consultation.

²¹⁶ These mitigations are set out in para. 96 below and discussed in detail in sections 4.9.2.1 to 4.9.2.5 below.

- ii. Its attempt to impose an intervention beyond its powers;
 - iii. Its application of a false counterfactual;
 - iv. Its failure to show a causal link from alleged concerns and its proposed remedy;
 - v. Its failure to conduct an impact assessment;
 - vi. Its failure to demonstrate any benefits from its Proposals; and
 - vii. The harm arising to investment and the industry from its Proposals.
6. The section then continues with an assessment of the disproportionate costs and disruption of Ofcom's Proposals (both its Preferred and Alternative Models), which are needless and unjustifiable. In particular, Ofcom's Proposals will result in the denial of shareholders' legitimate property rights, arising from Ofcom's two principal provisions:
- i. Independence, [§] amounting to virtual structural separation; and
 - ii. Incorporation, which would cause huge uncertainty and costs of change, particularly to the pension scheme.²¹⁷

4.2 Legal requirements; Ofcom's failure to satisfy its legal duties

7. Before it decides to intervene in a market, a regulatory authority is required, both as a matter of domestic and EU law and in accordance with the principles of better regulation and best regulatory practice,²¹⁸ to consider whether its proposed course of action is likely to have an impact on competition. It must also assess possible alternatives to ensure that any interference from its Proposals is kept to a minimum. Under domestic law, Ofcom is required to assess whether its Proposals are likely to affect the ability or incentives of BT to compete and, if so, carry out an in-depth competition impact assessment.²¹⁹

²¹⁷ The Openreach of the Ofcom Preferred Model would have: (a) high, recurring pension costs crowding out cash for investment; (b) high operating costs due to the requirement that it control its assets and people and arising from dis-synergies; (c) employees dissatisfied with being TUPE'd unwillingly into Openreach and frustrated with the loss, even if temporary, of the Crown Guarantee; (d) years of distraction, cost and uncertainty implementing the Ofcom Preferred Proposal; (e) years of uncertainty over its rights to use its assets compliantly with third party IP rights or even to rely on wayleaves to cross or enter premises; (f) a longer payback period for significant investments; and (g) a parent company more cautious about injecting cash into Openreach

²¹⁸ See Ofcom's duty under s3(3)(b) CA03.

²¹⁹ CMA50 Guidelines, Part 2, See also Ofcom's own guidance in Ofcom *Better Policy Making* 21 July 2005.

The impact assessment has to be carried out by reference to a “baseline” (also known as a “counterfactual”).²²⁰

8. The CMA recognises that measures that limit an entity’s organisation or structure can restrict its ability to compete,²²¹ as can measures which impede the firm’s incentive to innovate or which affect the price at which services can be supplied. Where there is a significant risk of distortion, the regulator must consider alternatives to mitigate the detrimental impact and cross-check those alternatives against its original proposal.²²² The impact assessment should be carried out to assess and measure the impact of competition, using a methodology based on a combination of qualitative and quantitative assessments.²²³ That will ensure that a reasoned judgment is reached about the preferred option for regulatory intervention that is supported by facts, economic argumentation and data about the relative cost-benefits of the proposal compared to the alternatives. For particularly significant or controversial issues, quantitative analysis is “*always preferred, where possible*”.²²⁴
9. Similarly, as part of its proposal under Art 13a AD, Ofcom is required to conduct an impact analysis and submit its conclusions to the Commission, setting out, with evidence to the standard of proof required, the impact of its proposal, inter alia, on the undertaking and its workforce, on the electronic communication sector as a whole, on incentives to invest in a sector as a whole and on other stakeholders including impacts on competition and on consumers.²²⁵ It also has to provide a reasoned justification why its proposal is the most efficient means to enforce remedies aimed at addressing the competition problems or market failures identified.²²⁶
10. Recital 61 of the Better Regulation Directive sets out the benefits and possible costs of functional separation and emphasises that its imposition must “*preserve the incentives of the concerned undertaking to invest in its network and [] does not entail any potential negative effects on consumer welfare*”.
11. BEREC (of which the CEO of Ofcom is of course a member) cautions that functional separation can only be imposed as an exceptional measure, and that “*according to the necessary analysis of proportionality, following the principles listed in Article 8 of the Framework Directive, the NRA will be required... to follow the specific procedures to justify the implementation of functional separation in the national markets.*”²²⁷ That entails an assessment that the

²²⁰ CMA50 Guidelines Part 2, paras. 2.10-2.13

²²¹ CMA50 Guidelines, para. 4.2 and 4.23.

²²² CMA50 Guidelines, paras. 7.1-7.3.

²²³ CMA 50 Guidelines, para. 8.1-8.3

²²⁴ CMA50 Guidelines, para. 8.3.

²²⁵ Article 13a(2)(c) AD and BEREC Guidance, page 12.

²²⁶ Article 13(a)2(d) AD and BEREC guidance, page 17.

²²⁷ BEREC Guidance, page 8.

proposed measure is appropriate and necessary to achieve the objectives legitimately pursued and that where there is a choice between several appropriate measures, recourse is made to the least onerous and that the disadvantages are not disproportionate to the aims pursued.²²⁸

12. BEREC recommends that both an impact analysis and an assessment of other possible regulatory/legal options available are conducted to justify why functional separation is considered the most efficient remedy.²²⁹ BEREC cautions that “*a quantitative assessment of both benefits and costs is likely to be very challenging*”²³⁰ and that “*the impact analysis ...could become the most difficult aspect of the whole analysis*”.²³¹
13. Neither the Initial Conclusions nor the July Consultation come close to discharging Ofcom’s obligations or best regulatory practice. In particular, Ofcom has failed:
 - i. To observe the substantive limits on the functional separation remedy that can be imposed pursuant to Art 13a AD;
 - ii. To identify an appropriate or realistic counterfactual with which to measure the effects of its Proposals;
 - iii. To demonstrate a causal link between its identified concerns and the remedy that it intends to impose;
 - iv. To carry out any form of impact assessment, whether qualitative or quantitative, of the cost and benefits of its Proposals;
 - v. To analyse the suitability of its Proposals for remedying the risk of strategic discrimination that it has identified;
 - vi. To consider how to mitigate any adverse detrimental impacts that its proposal entails for BT and competition and consumers more widely; and
 - vii. To assess the proportionality of its Proposals against the range of alternative means of remedying its concerns, including the voluntary model proposed by BT under Article 13b.
14. The first four matters are dealt with in this Chapter, focusing on Ofcom’s application of the wrong counterfactual and its failure to carry out a proper and substantiated impact assessment. In the next Section 5, we demonstrate that Ofcom’s Proposals are not the least onerous or most efficient means of achieving its strategic objectives. The new model of Openreach governance that BT is implementing effectively addresses the concerns expressed in the

²²⁸ BEREC Guidance, footnote 6 page 8 referring to the *Fedesa* criteria outlined in Section 2 above.

²²⁹ BEREC Guidance, page 17.

²³⁰ BEREC Guidance, page 13.

²³¹ *Ibid.* page 15.

DCR, whilst avoiding the disproportionate costs and complexities that would arise from Ofcom's Proposals.

15. In support of its response on these issues, BT refers to the following reports submitted with this Response:
- i. the two expert reports prepared by Compass Lexecon, the Compass Lexecon Main Report and "A review of CRA's 'The hold-up problem in vertically-related industries'" (the "**Compass Lexecon CRA report**");
 - ii. the KPMG report 'Impact of Ofcom's 26 July 2016 proposals for Openreach', (the "**KPMG Impact Report**");
 - iii. the KPMG report 'Impact of Ofcom's proposals for Openreach – Pensions Paper', (the "**KPMG Pensions Paper**");
 - iv. EY's report 'Openreach consolidation'; (the "**EY Consolidation Report**"); and
 - v. [X

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In addition to these experts' reports, BT also received some independent advice from its auditor, PwC, on the potential implications of Ofcom's Proposals, and refers to these reports:

- i. a report by PwC's pensions experts entitled 'Covenant ; considerations of Ofcom's 26 July proposal to reform Openreach's governance', (the "**PwC Pensions Report**");
- ii. PwC's report 'Accounting advice in relation to Ofcom's proposals regarding the strengthening of Openreach's independence' (the "**PwC Accounting Advice Report**").

4.3 Ofcom has applied an ultra vires remedy

16. Ofcom's Proposals mandate the imposition of independent governance on Openreach, by requiring it to undergo a corporate restructuring to become a distinct legally incorporated subsidiary within the BT Group.²³² This means it would become a company in its own right, with its own brand, corporate purpose, Articles of Association and governance arrangements. Under Ofcom's Preferred Model, Openreach would be directly responsible for its own employees and infrastructure assets associated with the Openreach network. It would be governed by its own Board of Directors, comprised of a majority of non-executive directors, including a Chair and a Chief Executive that are not affiliated in any way to the BT Group. There would be no reporting lines from the Openreach executives to the wider BT Group. Openreach would have

²³² See summary at para. 1.24, July Consultation.

delegated authority to develop and manage its strategy, financial expenditure and operations independently, subject to a maximum budget set by BT.

17. Ofcom states that its Preferred Model “*provides Openreach with the greatest degree of strategic and operational independence that is practically possible within a model of functional separation*”.²³³
18. Article 13a(1) defines functional separation obligation as:

“*an obligation on vertically integrated undertakings to place activities related to the wholesale provision of relevant access products in an **independently operating business entity**.*

That business entity shall supply access products and services to all undertakings, including to other business entities within the parent company, on the same timescales, terms and conditions, including those relating to price and service levels, and by means of the same systems and processes” (bold emphasis added).
19. The meaning of the emphasised wording is to be read against recitals 61 and 62 of the BRD, explaining the introduction of this additional and exceptional power:

“(61) *The purpose of functional separation, whereby the vertically integrated operator is required to establish **operationally separate business entities**, is to ensure the provision of fully equivalent access products to all downstream operators, including the operator’s own vertically integrated downstream divisions. ...*

“(62) *The implementation of functional separation should not prevent **appropriate coordination mechanisms between the different separate business entities** in order to ensure that **the economic and management supervision rights of the parent company are protected**”* (bold emphasis added).
20. BT considers that this is a further element in the Ofcom Preferred Model that fails to observe the proper limits of Article 13a, in this case as a matter of substance rather than jurisdiction or procedure:
 - i. Functional separation as defined in Article 13a, is an “exceptional” remedy of last resort which must be construed narrowly as a derogation from the ordinary SMP remedies in Articles 9 to 13;
 - ii. Read in the light of these recitals (and the contrasting wording of Art 13b AD), Art 13a AD envisages the transfer of assets into an **independently operating business entity** and no more. It does not contemplate a mandatory transfer of assets either to a ‘*separate legal entity under different ownership*’²³⁴ or to a business entity that may be

²³³ Paras.1.23 and 4.9, July Consultation.

²³⁴ See Art 13b(1) AD for the possibility of **voluntary** structural separation.

nominally owned by its parent company but that is no longer subject to effective control; and

- iii. Recital 62 to BRD makes it clear that the EU legislator was concerned to make it clear that such regulatory intervention:
 - i. should not ‘prevent appropriate coordination mechanisms’; but
 - ii. should ‘ensure that the economic and management supervision rights of the parent company are protected’.
21. In substance, the effect of these provisions is that, while the separate business entity should be **operationally independent**, that independence should not be such as to undermine the ability of the parent company to **control** that entity, thereby ensuring appropriate coordination and economic and management supervision by the parent company.
22. Ofcom’s Proposals fail to respect this distinction and spills over into a situation in which BT can no longer exercise effective supervision or control over Openreach. This degree of independence, which allows BT so little influence over Openreach [✂], and would deny the shareholders in Openreach the right to enjoy the ownership of their assets, formally retains the same legal ownership but requires it to be exercised in a vacuum.
23. Indeed, Ofcom’s Proposals are akin to a form of “virtual structural separation” (particularly in case of the transfer of assets and employees envisaged in Ofcom’s Preferred Model) but, in some highly material respects, is an inappropriate “half way house”. Ofcom achieves the worst of both worlds, in that BT retains nominal ownership of Openreach without any effective control. Such a relationship between a company and its shareholders is a non-viable solution. A public company could not tolerate such an arrangement day-to-day nor would it be consistent with its listing and corporate obligations. The directors could not fulfil their fiduciary duties to shareholders of a public company. BT may not be able to sustain its listing. BT would not be able to comply with the requirements of good corporate governance.
24. Ofcom’s Proposals therefore fall outside Article 13a AD as a matter of substance and means Ofcom is acting outside its statutory powers. Ofcom has no power to impose either mandatory structural separation or a form of virtual structural separation that undermines the supervisory role of BT as owner of Openreach to such an extent as to create an incoherent divorce between nominal ownership and effective control.

4.4 Application of the wrong counterfactual

25. Ofcom states that its proposed remedy “*is intended to ensure that Openreach makes strategic decisions in a manner that reflects the interests of all its customers. Any model that does not achieve this does not resolve our competition concern.*” Ofcom also seeks to defend its proposal on proportionality grounds as a less onerous remedy than structural separation

which is considered by Ofcom to remain “a *credible option*”. Ofcom states, “[w]e remain of the view that structural separation is a *credible option*, but believe that it would be disproportionate to move to structural separation without first giving BT an opportunity to make legal separation work”.²³⁵

26. Put simply, Ofcom relies on the assumption that the costs of its proposal are less than the costs of structural separation in order to justify its intervention. The assumption is unevidenced but, more fundamentally, even if a proper cost comparison were undertaken, Ofcom can derive no conclusion on proportionality when structural separation itself is not the correct counterfactual to its own proposals and has not been shown by Ofcom to be likely to deliver the market outcomes it is seeking.
27. Ofcom’s approach is also flawed because it has not, as required by Article 13a AD and ss. 89A and 89B CA03, shown that its Proposals are the most efficient means to achieve its objective – they are not. This would require a consideration of alternative approaches to addressing the alleged competition concern, and specifically their relative costs and benefits, if Ofcom were to be able to show that its preferred intervention would be “the most efficient means to enforce remedies aimed at addressing the competition problems/market failures.” Ofcom has not undertaken any such analysis, and the finding from any such analysis would show that Ofcom’s is a disproportionately expensive and disruptive proposal. It is not an appropriate remedy for any well founded concerns and certainly not the most efficient.
28. A proper impact assessment and proportionality analysis cannot be conducted in the abstract but has to be measured by reference to a realistic counterfactual – i.e. the situation in the absence of the Preferred Model. That may be the existing status quo under the Undertakings and/or the scenario set out in the BT Proposal dated 18 July 2016.²³⁶
29. This is an error of law and of principle that is contrary to Ofcom’s own administrative guidance. Ofcom starts from the wrong premise, as its proportionality assessment is conducted “*within a model of legal separation*” without establishing a baseline to compare a range of alternative means of intervention first. It is putting the cart before the horse. As the Compass Lexecon Report observes, Ofcom should, consistently with the recommended position in its own Guidelines,²³⁷ have started with the status quo first to assess

²³⁵ Para. 4.10, July Consultation.

²³⁶ BT has notified a model of separation to Ofcom which it intends to implement on a voluntary basis. Going forward, therefore, Ofcom must show that it is justified and proportionate to impose an exceptional remedy that goes beyond BT’s implementation plans (assuming it is able to make a cogent case that there are important and persisting competition problems and/or market failures attributable to discriminatory behaviour). As stated by Compass Lexecon, “*If, hypothetically, Ofcom were to substantiate its concerns, it would then need to address the degree to which its own Proposal addressed these concerns over and above the benefits of BT’s Proposal and compare the associated cost*”, para. 5.56, Compass Lexecon Main Report.

²³⁷ Ofcom *Better Policy Making*, paras. 3.3 and 5.24.

whether any form of intervention (including lesser forms of functional separation) would represent an improvement over the status quo.²³⁸ Ofcom adopts the wrong counterfactual and one which assumes that there must be changes to governance at the outset. It thereby uses the wrong reference point for assessing the various alternatives and wrongly concludes that its intervention is proportionate because it is the least onerous means of implementing legal separation. In so doing, it fails to properly assess whether other less restrictive alternatives might be more appropriate and proportionate.

4.5 Failure to show a causal link

30. Ofcom is required, under the ERF (see in particular Art 8(4) AD) and CA03 (e.g. at s.47(2)(c)), to select the most efficient remedy that is capable of addressing the concerns it has identified. Its intervention must be reasonable and proportionate and “*targeted only at cases where action is needed*”.²³⁹ As set out in Section 3 above, Ofcom has failed to identify any real concerns that are sufficient to trigger Art 13a AD. Moreover, even assuming it had done so, Ofcom has not attempted to assess the likely incidence or nature of strategic discrimination occurring or estimate the expected scale of costs associated with it.²⁴⁰
31. Ofcom does not evidence or explain how its Proposals will causally deliver its desired outcomes in terms of preventing strategic discrimination. For instance, it does not demonstrate that its Preferred Model is the sole means of achieving them. Indeed, it recognises that consumer and business outcomes are not “*completely under Openreach’s control*” and will need to be “*complemented by [Ofcom’s] wider programme of work under the DCR strategy*”.²⁴¹ Similarly, it concedes that concerns about delivery of FTTP or service levels are not related to BT’s vertical integration. As Compass Lexecon observes, the absence of any causal link between Ofcom’s stated concerns and its Preferred Model undermines any claim of potential benefits that would be attributable to this remedy.²⁴²
32. In order to justify its proposed intervention, Ofcom would need to substantiate its concerns relating to strategic discrimination (which it has not), and explain how the proposed remedy will deliver Ofcom’s desired outcomes by reference to a plausible causal mechanism. In other words, improved industry and consumer outcomes from avoided discrimination must be evidenced **and** causally connected to the proposed remedy.

²³⁸ Paras. 5.5–5.7, Compass Lexecon Main Report.

²³⁹ S.3(3)(a) CA03.

²⁴⁰ Para. 5.11, Compass Lexecon Main Report.

²⁴¹ Para. 6.3, July Consultation.

²⁴² Para. 5.10, Compass Lexecon Main Report.

4.6 Failure to carry out a proper in-depth impact assessment

33. Ofcom has failed to perform the requisite impact assessment in order to evidence that its proposals are effective and proportionate relative to a counterfactual of no intervention and alternative interventions (as discussed above). Compass Lexecon comments, in this regard, that Ofcom has failed to observe best regulatory practice. It states, “*We consider it self-evident that any regulatory intervention should be effective, net beneficial, and proportionate to the issue it seeks to address. This requires demonstrating, by means of a robust cost-benefit analysis, that the intervention will create benefits in excess of its costs both with respect to a counterfactual of no intervention and with respect to alternative interventions. This approach is identified as best regulatory practice in regulatory guidance, including Ofcom’s own guidance, and is central to the economic provisions under Article 13a.*”²⁴³
34. A proper impact assessment is required in order to guard against the imposition of a disproportionate remedy which is not capable of appropriately addressing Ofcom’s concern (assuming that such a concern were to be robustly identified). It would need to establish what, if any, benefits flow from Ofcom’s Proposals and whether they exceed the associated negative effects (referred to as “costs”) for BT and the sector as a whole. It also requires a comparison of those costs and benefits with the negatives generated under the status quo (or other counterfactual). That analysis cannot be conducted in generalised terms but has to be measured, qualitatively and/or quantitatively,
35. BT considers that Ofcom’s Proposals are not capable of addressing Ofcom’s hypothetical concern because there is no plausible causal mechanism linking this concern with Ofcom’s proposed intervention. As such, there are no identifiable benefits to weigh against what are substantial and verifiable economic and implementation costs (in particular the loss of vertical coordination benefits resulting in less investment) as discussed further below.
36. Even assuming that Ofcom could demonstrate some benefits from its proposed intervention, it must then show that the benefits exceed the associated costs, having made a diligent appreciation of both the one-off costs as well as the on-going adverse economic impacts for BT and the sector as a whole.
37. Our evidence shows that Ofcom’s Proposals would involve disproportionate costs and other harmful economic consequences and that it would not be workable in practice. Far from being a beneficial regulatory intervention, Ofcom’s Proposals are harmful to the sector with detrimental effects for investment, competition and consumers.
38. The sections below address the following:
- i. Ofcom has not demonstrated the benefits of its Proposals;
 - ii. the harm to the sector due to detrimental effects for investment with adverse consequences for competition and consumer;

²⁴³ Para. 5.2, Compass Lexecon Main Report.

- iii. inadequate analysis of implementation and ongoing costs to BT arising from BT's Proposal.

4.7 Ofcom has not demonstrated the benefits of its Proposals

39. As set out in Section 3 and the Compass Lexecon report, Ofcom does not provide evidence to substantiate its concerns and, therefore, provides no evidence for any potential benefit that Ofcom's Proposals could produce.
40. Ofcom identifies three broad categories of benefits from its Proposals as follows:²⁴⁴
- i. that independent decision making, without influence from the BT Group and greater transparency from the new governance process will change Openreach's behaviour and priorities and make it more responsive to consumers;²⁴⁵
 - ii. maintained intensity of competition and reduced influence from the BT Group over the design and investment models so that investments are driven by UK consumers and businesses with the result of new risk sharing and co-investment opportunities;²⁴⁶ and
 - iii. improved outcomes for consumers and businesses, including increased availability, quality choice and pricing of broadband services.
41. Ofcom does not explain how those benefits (i.e. improved industry and consumer outcomes) relate to its concerns of strategic discrimination.
42. For example, Ofcom refers to "*improved investment outcomes arising from new potential models of investment, such as co-investment and risk sharing*". Ofcom suggests that alternative approaches to investment may not be fully tested under current arrangements and that, with greater autonomy, Openreach would be more likely to reach co-investment or risk sharing agreements with operators other than BT.²⁴⁷
43. The likelihood of co-investment and risk sharing models emerging to deliver major new investments is not a question of whether or not Openreach is more autonomous but whether, in practice, they are more effective in mitigating risk. If they are, there is nothing stopping Openreach from reaching such agreements under the current arrangements, subject to their being compliant with equal access regulations. As noted above, Openreach already has strong incentives to meet consumer demand for innovation and services in order to remain competitive with Virgin Media and others including 4G networks.²⁴⁸ There can be no suggestion that these incentives are constrained by a lack of

²⁴⁴ Para. 6.2, July Consultation.

²⁴⁵ Paras. 6.5-6.6, July Consultation.

²⁴⁶ Paras 6.7-6.15, July Consultation.

²⁴⁷ Para.1.47, July Consultation.

²⁴⁸ BT also has regulatory incentives deriving from its USOs.

available funds which a co-investment model might address, as BT has ready access to capital markets. As noted by Enders, “[w]e regard this as making little sense; BT has plenty of access to the capital markets, so if an investment is worth making, it will make it, and we see very little chance of BT’s competitors being willing to stretch a business case further than BT.”²⁴⁹

44. As discussed in detail in the next section, these arrangements are rarely seen because they are **less** effective in mitigating risk, not because they are prevented by the existing structural arrangements. Moreover, such arrangements pose significant challenges for the promotion of competition through Eol access regulation; an issue which has not been addressed by Ofcom.

4.8 Ofcom’s Proposals are harmful to investment and to the industry as whole

45. Even if Ofcom could demonstrate the benefits of intervention, it must then show that the benefits exceed the associated costs. As set out below, BT believes that Ofcom’s Proposals are likely to be deeply harmful to investment and the industry as a whole, incurring significant economic costs which have not been analysed by Ofcom, notably in relation to investment.

4.8.1 Vertical integration efficiencies under the status quo

46. There are clear advantages to BT Group retaining economic control of Openreach arising from increased incentives to undertake investment, to the benefit both of consumers and to downstream competitors who are able to compete more effectively by means of the improved upstream products. In a network industry that requires significant investment to promote technological progress, and where there is a significant degree of demand risk,²⁵⁰ this is an important benefit which should result in a high degree of caution before putting coordination mechanisms at risk.
47. Maintaining Openreach as part of BT Group, together with appropriate economic and management supervision rights, supports continued investment in the access network. Openreach has access to an anchor tenant (namely BT’s downstream operations) to whom it can market new services, ensuring that new network assets are utilised quickly. This offers significant risk mitigation and co-ordination advantages for the following reasons: (i) investments are actively marketed and sold without the risk of them standing idle or largely under-utilised for very long; and (ii) the risk of opportunistic re-negotiation of terms once the investment has been made is removed.²⁵¹

²⁴⁹ Openreach: The Seventh Degree of Separation, Enders Analysis 4 August 2016.

²⁵⁰ This feature distinguishes telecoms from other utilities which benefit from having a largely stable level of demand which is guaranteed into the future.

²⁵¹ As Compass Lexecon explains, hold-up costs are a key issue for any costs-benefit analysis of vertical separation. Once BT makes customer-specific irreversible investments, it becomes exposed to the risk of customers seeking to renegotiate trading terms to force a

48. Moreover, BT can look at both Openreach's returns and the margins made at the retail level to justify business decisions. Returns at both of these levels reduce the risk and pay-back periods that Openreach investments would otherwise face. In short, major network investments require coordinated commitment and end-to-end margins in order to make the business case pay back.
49. In addition, the end-to-end view allows investment to be appropriately "market tested" as BT's retail margins will reflect the value placed on investments by BT's end user, as well as the market more generally (because BT's retail returns are a good proxy for the returns of other CPs given the protection provided by ex-post and ex-ante margin squeeze rules).
50. BT's investment in FTTC benefitted significantly from these vertical integration efficiencies. The investment risk was mitigated by the fact that Openreach had an assured route to market via BT's retail division which was a "committed retailer" that could be relied on to make every effort to market the new service. BT's retail operations actively marketed fibre broadband ahead of other CPs who opted to wait and see whether demand could be stimulated.²⁵² Moreover, the FTTC investment case relied on end-to-end margins to have the best chance of achieving an acceptable commercial pay-back.
51. BT's investment showed a 12 year payback for BT Group. However, the payback at the Openreach level (reflecting wholesale margins only) was 19 years; if Openreach had had to decide unilaterally whether to invest in fibre broadband simply on the basis of its own returns, at a payback of 19 years, it would not have been able to take such a risk. In the event, other CPs chose not to sell fibre broadband in significant volumes until three years after BT had launched. Analysis by BT demonstrates that if BT's downstream operations had acted as other CPs did, and waited for three years until selling it in volume, the Openreach case would have stretched further into the future, by about another five years, making the investment case non-viable. In 2015/16 for example, volumes would have been more than 50% lower than those that were actually achieved because BT effectively marketed fibre broadband (as shown in the Figure below).

[X]

lower price. This "hold-up" problem reduces the expected benefits from the investment and may deter investment in the first place. Paras. 5.37-5.41, Compass Lexecon Main Report.

²⁵² Other major CPs have publically acknowledged they adopted a "wait and see" attitude whilst BT forged ahead. For example, Jeremy Darroch, BSkyB CEO, said in November 2010 that: "*If there is demand for fibre from our customers, we will look to provide that but we are not going to rush into that until we see real levels of customer demand that are attractive.*" Financial Times, November 17, 2010. As recently as May 2014, Dido Harding TTG CEO commented that: "*...fibre is a premium product that really is only appealing to customers who've got poor broadband speeds.*" TalkTalk Telecom Group PLC Earnings Conference Call, May 15 2014.

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4.8.2 Adverse effects of Ofcom's Proposals on investment

52. Ofcom's Proposals, by overly restricting the ability of BT Group to allocate capital to Openreach on the basis of end-to-end returns to its capital, risk losing these benefits, to the detriment of investment and, ultimately, of end consumers.
53. More specifically, BT understands Ofcom's Proposals to entail that BT Group will only be allowed to set an overall investment budget (or "financial envelope") for Openreach without influence over its content (i.e. the detailed strategic and operational plans - including investment plans – which would be developed by the Openreach executive, approved by the Openreach Board, and a "high level summary" provided to the BT Group Board "for information only").²⁵³
54. Put simply, delivery to the financial envelope would be delegated to the Openreach Board which must independently determine its priorities "*in the interests of all its customers*".²⁵⁴ In addition, the Articles of Association for Openreach would specify that a core purpose is to act in the interests of all downstream customers equally, and the Openreach Directors would have duties to act accordingly.²⁵⁵

²⁵³ As explained in Section 4, a key feature of Ofcom's proposal is that Openreach should have greater independent financial control within an agreed budget. Ofcom states that "*BT Group would set a 'financial envelope' (a set spending capacity). Within this envelope, Openreach would have delegated authority to develop and manage its own strategic and annual operating plans. Openreach would also be able to make recommendations to the BT Group Board for increased spending.*" Paras. 1.24 and 4.41, July Consultation.

²⁵⁴ Para. 4.45, July Consultation.

²⁵⁵ See Section 4.9.1.

55. BT understands this to mean that:
- i. Openreach will decide upon and undertake investment within the envelope without reference to (or knowledge of) downstream BT interests (except in the context of consultation exercises which would also involve other CPs). Therefore investment decisions within this budget must be on the basis of Openreach margins only; and
 - ii. Where Group retains the ability to approve or reject expenditures outside of the envelope,²⁵⁶ it is not clear that Group can factor into that decision the wider spillovers to other BT divisions, without being deemed to have exerted “strategic influence”. Ofcom specifically identifies as a potential measure of success, against which to judge the effectiveness of its model, “[t]he ability for Ofcom to assess whether Openreach Board decisions are taken independently, without undue influence from BT Group.”²⁵⁷ BT interprets this to mean that any attempt by BT Group to exert influence, including by making decisions on additional expenditure proposals on the basis of wider Group interests, would be treated by Ofcom as “undue influence” and would be deemed a failure of what Ofcom describes as “the most direct measure of success”.
56. This is fundamentally different to the status quo (and indeed BT’s Proposal) where – as described above - BT Group does take into account the wider interests of the Group when developing new products and making investment decisions that shape the network, and has the ability to direct Openreach to make investments which deliver value from a Group perspective.
57. Compass Lexecon indicate that this “*would be a fundamental change, amounting to quasi-structural separation with respect to how Openreach and BT Group would approach investment decisions, and as a result would be likely to result in the types of costs that economists normally associate with structural separation.*”²⁵⁸
58. These aspects of Ofcom’s Proposals will have a number of adverse effects on BT’s investment incentives and decisions and Compass Lexecon also cautions that there will be economic costs associated with the separation of Openreach which will prevent investment decisions being taken with a holistic integrated vision.
- **Reduced investment – 1) from preventing BT from taking an end to end view.** As illustrated by the simple table below: the set of investment cases that are NPV+ just on Openreach margins must be

²⁵⁶ Ofcom proposes that any Openreach proposals requiring additional expenditure outside the financial envelope are recommended to the BT Group Board for approval. The BT Group Board would then consider the proposal and accept or reject it. Para. 4.54-4.62, July Consultation.

²⁵⁷ Para. 6.6.1, July Consultation.

²⁵⁸ Para. 3.12, Compass Lexecon Main Report.

less than the set of cases that are NPV+ on Openreach and retail margins.

	Retail margins	Openreach margins
Current arrangements	+	+
Ofcom proposal	n/a	+

59. For large scale investments such as G.Fast, FTTC and FTTP, BT has historically been able to have regard to the likely take up and likely profits from BT's retail divisions in assessing the investment. As indicated above, those assumptions are critical to deciding to invest in the first place on the basis of the likely return on any investment and likely pay-back. If Openreach is to make similar investment decisions in isolation, acting within the financial envelope but without reference to BT's downstream interests, then it may have a chilling effect on investments.
60. The Compass Lexecon report comments on this effect as follows: "*in the status quo, BT may also take into account the effects on BT's downstream profits when assessing the profitability of Openreach investments. We understand that this has been a consideration in the context of large-scale investments. Structural separation and ... quasi-structural separation would remove this integrated view and may thereby reduce Openreach investment incentives.*"²⁵⁹
- **Reduced investment – 2) from removing the anchor tenant.** Openreach will not be able to invest with confidence that BT will act as an anchor tenant (ex-ante): it will only be allowed to rely on the commitments stated through the new consultation process and should weigh the commitments of all downstream CPs equally.

In other words, where Openreach is obliged to make investment decisions, if Openreach is to treat BT's downstream operations as if it were a non-integrated CP, without reference to (or knowledge of) downstream BT interests, the implicit contract is broken and Openreach must take into account the risk of BT's retail operations behaving opportunistically post investment. More specifically, Openreach will not have the comfort of any implied commitment that BT downstream will act as an "anchor tenant" with a minimum commitment to support its investments. Openreach is likely to be more cautious in its investment strategy, which will not be consonant with Ofcom's strategic objectives in promoting the roll-out of superfast broadband, increasing innovation and improving service quality.

²⁵⁹ Para. 5.44, Compass Lexecon Main Report.

Compass Lexecon identify that, in the event Ofcom substantiates its strategic discrimination concern (i.e. which is based on the premise that investments have a degree of specificity to individual downstream buyers) then these are precisely the circumstances in which investment hold up problems can arise, and therefore hold-up costs (i.e. the chilling effect on investment arising from the risk of ex post renegotiation of terms by customers) are a key issue in any cost-benefit analysis of structural or quasi-structural separation. Compass Lexecon also identify circumstances in which hold up problems can arise even in circumstances where investments are of common utility due to the risk of ex post re-negotiation of funding commitments by customers seeking to free ride on the commitments of others. In both cases, Compass Lexecon identifies that an assessment of the feasibility and costs of designing effective contracts is required, noting the complexities in this regard, in particular *“the extremely large and the long-term nature of investments and the high degree of uncertainty about demand conditions when the investments would come to be commercialised and over the life of the investment”*.²⁶⁰ The obstacles to effective contracting posed by Openreach’s equal access obligations are also noted.

- **Reduced investment – 3) from principal-agent complexity.** The implication of weakening BT Group’s oversight of Openreach performance by limiting it to the financial envelope is that BT is exposed to a risk described in economic terms as “moral hazard” (i.e. the tendency of parties to take more risk when someone else bears the cost of that risk). In other words, large budgets would need to be agreed to allow Openreach (independently) to identify, for example, national FTTP roll-out as its investment priority. But Openreach could decide to use the budget in another way, and the weakened oversight of these decisions may limit BT’s incentive to provide funding to Openreach as compared to the status quo. The Compass Lexecon report highlight this risk as follows:

*“Whereas Ofcom’s Proposal would give Openreach control over how to deploy its budget, the Proposal may hence as a direct consequence thereof incentivise BT to reduce the amount of funding to Openreach in response to the associated risks. This is a critical issue for the extent to which Openreach in fact would be able to meaningfully choose between, or implement at all, “key decisions that shape the network”. It is also critical in relation to the question of whether Ofcom’s Proposal may lead to higher investment levels, including through co-investments with other CPs.”*²⁶¹

²⁶⁰ Para 5.50, Compass Lexecon Main Report.

²⁶¹ Para. 5.50, Compass Lexecon Main Report. Compass Lexecon also indicate that the internalisation of downstream margins in an integrated structure may lead to greater investment as compared an independent, but regulated, Openreach because of the risk of regulation under-remunerating investment. In particular the recovery of investment costs may be limited because of concerns that Openreach would use its informational advantage

- **Investment not in the interests of end users.** Openreach would be removed from retail demand. Prioritising returns at the Openreach level, may not result in investments in capabilities and services that are the closest match to the needs of the retail market with adverse effects for all CPs, not just BT's own retail divisions. The identification of end user needs and appropriate technology choices to meet these needs would be done, under Ofcom's Proposals, through consultation and contracts which is likely to involve a much greater degree of friction than vertical integration (particularly where coordination across multiple retail operators is required, for example in risk sharing arrangements). In particular, without retail margin integration, Openreach will lose a strong signal of end user value (for both BT and CPs).²⁶²
 - **Competitiveness of Openreach undermined.** Openreach would be unable to compete effectively with Virgin Media. Virgin Media makes investment cases on the basis of its end-to-end margins, across 100% of its customers (because it offers no wholesale supply), with a higher retail average revenue per user than BT's retail average revenue per user.
61. In short, the governance arrangements which are designed to prevent Group from favouring investments that give preferential treatment to the interests of BT's own downstream divisions over its competitors, also prevent Group from improving investment cases by recognising downstream commitments and margins and will prevent BT from competing effectively with other vertically integrated players, in particular Virgin Media.
62. BT's Proposal, on the other hand, is carefully designed to strike the appropriate balance and avoid that happening (as discussed further in Section 5).

4.8.3 Existing coordination mechanism cannot be replicated through contracts

63. There is no evidence or analysis to support the extremely unlikely contention that the coordination mechanism outlined above, and its role in supporting investment, can be replicated by designing and enforcing contracts that enable the sharing of the risks and benefits of the specific investments (i.e. through co-investment and risk sharing models).²⁶³ As indicated above, such models are

to insist on costly projects (i.e. a moral hazard problem). In an integrated structure where the upstream division is risking the money of the vertically integrated group, the regulator's concern about moral hazard will be mitigated.

²⁶² Para. 5.46, Compass Lexecon report "Openreach also benefits from access to, for example, BT Retail's insights about consumers' needs and the technology choices that may address these needs. As vertically integrated entities, BT Retail has an incentive to provide such insights in a timely and unbiased manner and Openreach can act on these insights with this knowledge. Such incentives are unlikely to be replicable through contracts rather than integration."

²⁶³ One of the goals of Ofcom's intervention is identified as "*improved investment outcomes arising from new potential models of investment, such as co-investment and risk sharing*", para. 1.47, July Consultation.

unproven and likely to be complicated by Openreach's obligation to supply all buyers on equal access terms.

64. Ofcom elaborates on how this might unlock investments as follows:

*"These [risk sharing and co-investment opportunities] make it easier to deploy new networks, including those based on fibre to the home. This is because they allow the demand from different providers to be aggregated, thereby making it easier to achieve the necessary penetration for such deployments to be profitable, and they spread the associated risk across multiple providers."*²⁶⁴

65. Sky also refers to co-investment models as follows:

"For Openreach, it would be free to coordinate with all of its customers, not just with BT Retail as it claims it does today, to help underwrite significant new network investments. These arrangements which could include co-investment models, anchor tenancy agreements or minimum guarantees would be significantly more effective in mitigating investment risk than the current model – particularly where it relates to demand risk. Notably, this model of greater coordination between Openreach and its downstream customers need not entail Openreach increasing its overall level of investment - although this too is likely. Downstream operators would be inclined to invest more themselves."

66. Formalising risk allocation through contracts across multiple third parties in the context of large scale investments, the benefits of which will not be known for many years, presents a range of challenges:

67. **Specification risk** – in a contractual setting, the incentives for efficient investment depend on the agreement of the parties to a full set of long term, detailed contracts ahead of the investments being made. There are, however, very significant challenges to writing effective contracts when outcomes are uncertain - when costs and technologies are unclear, where future demand in terms of take-up, willingness to pay and profitability are unclear, where competitive reaction is unpredictable over a long period of time - and where there is complexity in the product (or product set) which is traded between the contracting parties, as there is in relation to next generation access investments. Uncertainty and complexity require very detailed contracts which may need to be contingent on many possible factors, such as potential changes to quality, future levels of demand, changes in technology and regulatory risk (particularly where co-investment parties may have options created through regulation and other than investment). But such contracts, needing to be agreed ahead of knowledge of many factors, become prohibitively expensive to write and enforce and are therefore seldom seen. BT considers that the required commitment cannot be easily replicated by contractual means and

²⁶⁴ Para. 6.13, July Consultation.

therefore any intervention which relies on such models to emerge and counter the adverse effects on BT's incentives to invest would be entirely speculative and not consistent with the requirement of the EU regime that investment incentives should be preserved, and adverse effects on consumer welfare avoided.²⁶⁵

68. Sky has submitted that hold-up problems may be avoided by contractual arrangements;²⁶⁶ that appears to be unjustifiably optimistic. As Compass Lexecon explains, there are limits to designing risk-sharing contractual arrangements given the long term nature of investments in network infrastructure and the high degree of uncertainty regarding demand conditions.²⁶⁷
69. **Regulatory issues** – these models of investment are unlikely to be consistent with Eol requirements. Typically in a co-funding arrangement, parties contributing capital would expect usage charges below average cost (with the level of discount increasing with the level of up-front contribution). This might need to sit alongside higher access charges for parties who have not contributed capital which, under current arrangements, would not be compatible with Eol regulation. As the Compass Lexecon report indicates *“it is not clear whether any third parties would be willing to co-invest without the prospect of gaining some competitive advantage by doing so. This in turn would create the possibility for discrimination between co-investors and other downstream buyers as it is not clear, and not explained by Ofcom, how EOI would apply to these arrangements.”*²⁶⁸
70. Put simply, if such contracts would need to respect Openreach's Eol obligations, then CPs will have little incentive to commit funds as the benefits of any pre-commitment that they might be willing to make would be shared with their rivals. However, if Eol were not to apply in cases where there were differential levels of investment, then there would be adverse implications for competition at the retail level. Ofcom has made no case that it is better for end-customers in terms of availability of services, their prices, choice or innovation that equal access should be sacrificed in favour of exclusive co-investment arrangements.
71. If the removal of Eol were to be considered to be a policy option, then there could be many ways to drive different market outcomes other than simply by co-investment. Compass Lexecon comment on this trade off as follows:

“...even a hypothetical benefit from further co-investment may be difficult to achieve in practice whilst maintaining EOI access. The cost of such co-investment/anchor tenancy/minimum guarantee driven

²⁶⁵ BT Response to Discussion Document, Section titled, “Economic impact of integration” page 103.

²⁶⁶ CRA Paper “*The Hold-up Problem in Vertically Integrated Industries*”.

²⁶⁷ Paras. 5.15-5.16 and 5.39-41, Compass Lexecon Main Report.

²⁶⁸ Para. 5.15, Compass Lexecon Main Report.

investments may therefore be a weaker EOI regime, if EOI is at all practically feasible in that context, with potential implications for retail competition."²⁶⁹

72. In Portugal, operators have built FttH access infrastructures, and effectively exchanged IRUs with one owner granting long term rights to customers in some part of its footprint to another operator, in return for receiving reciprocal and exclusive awards in the user's own footprint. Such exchanges have been made on a commercial basis and in the absence of non-discrimination requirements, which would prohibit exclusive arrangements of the type made in Portugal.
73. **Lack of precedent** – it is notable that the overwhelming choice of technology-driven telecoms suppliers is to be integrated. That alternative forms of organisation, in particular co-investment models to upgrade regulated access markets, are likely to be more efficient is contradicted by this basic observation. Although co-investment and risk sharing arrangements are possible under current arrangements, they have not been adopted. In 2012, Ofcom informed BEREC there was little interest in co-investment in the UK, so Ofcom had not considered regulatory issues around infrastructure cost sharing on regulatory terms²⁷⁰ (as used in France, Portugal and Spain). As set out in Annex A, the arrangements in these countries reflect specific country circumstances which do not apply in the UK. In particular, limited wholesale access regime, including no active remedies and, with low FTTP deployment costs, has resulted in entrants installing their own FttH infrastructure with co-investment arrangements focused on the final connection to the customer (i.e. sharing of in-building wiring in Portugal, and Spain, or to a broadly equivalent fibre terminating segment in France). In these countries, co-investments have tended to involve standard facilities (i.e. in-building wiring) as opposed to new and emerging technologies, all of which has been supported by the use of symmetrical as opposed to the asymmetrical regulation in the UK.
74. In the absence of viable alternative coordination and risk mitigation strategies, the existing structural and governance arrangements allow investment to occur which would not otherwise be viable.
75. In summary, Ofcom's Proposals are deeply harmful to the industry. In principle, Openreach would be unduly constrained, unable to invest to meet customer needs and unable to compete effectively.

4.9 BT's analysis of the costs and complexities that Ofcom's Proposals would involve

76. Ofcom's Proposals comprise two main provisions, the independence of Openreach and its incorporation as a separate legal entity. This Section 4.9 considers the costs of what each provision would involve for BT.

²⁶⁹ Para. 5.15, Compass Lexecon Main Report.

²⁷⁰ BEREC, "Report on Co-investment and SMP in NGA networks" (2012).

4.9.1 Independence of Openreach

77. Ofcom proposes that Openreach shall have the “*greatest degree of strategic and operational independence that is practically possible*”²⁷¹ (e.g. para. 4.9). It is BT’s strongly held conviction that this degree of independence (amounting to “virtual structural separation”) is incompatible with: a) accounting requirements; b) company law; c) listing requirements; (d) access of information in the context of the Disclosure and Transparency Rules (“**DTR**”) and the Market Abuse Regulation (“**MAR**”); and (e) good corporate governance. It is also, for the reasons set out in Section 4.2 above, contrary to the substantive limits imposed by Article 13a AD and the European Regulatory Framework.

4.9.1.1 International Financial Reporting Standards²⁷²

78. This degree of independence for an incorporated Openreach subsidiary of BT, as set out in Ofcom’s Proposals [~~§~~

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79. For an entity to be consolidated, it must meet the definition of a subsidiary as defined in Appendix A of IFRS 10, Consolidated Financial Statements. A subsidiary is defined as “an entity that is controlled by another entity”. An investor (BT) controls an investee (Openreach), if and only if, the following are satisfied (IFRS10.7):

- i. it (BT) must have power over the investee (Openreach) – the “current ability to direct the relevant activities” (IFRS10.10);
- ii. it must be exposed to variable returns; and
- iii. it must be able to use that power to influence the returns that BT gets from Openreach.

80. [~~§~~

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81. [~~§~~

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²⁷¹ Paras. 1.23 and 4.9, July Consultation.

²⁷² [~~§~~

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²⁷³ [~~§~~

]

- Power over the investee to direct the relevant activities:
 - i. BT's rights (as sole shareholder of Openreach) would only be administrative since the relevant activities of Openreach will be directed by the executive directors (who are not appointed by BT and without reporting lines to BT executives). To determine power, an investor must have substantive rights and not just rights that are protective in nature. For example, BT's right to approve any major investments outside the AOP financial envelope does not provide BT the ability to direct the investment itself and is a protective rather than substantive right.
 - ii. Contrary to BDO's views, the power to appoint or remove a majority of directors is not (alone) an indicator of power to direct the relevant activities of Openreach, as other factors must be considered including governance structure, Ofcom's rights over such appointments and financial control arrangements.

It ensues from the Ofcom Proposals that BT does not have unfettered rights to remove and appoint all the directors, as either BT must consult with Ofcom and obtain approval, or the directors are appointed by the Openreach board.²⁷⁴

- Exposure to variable returns
 - i. Whilst BT's exposure to losses incurred by Openreach is significant, its exposure to gains is limited as BT does not have significant influence in determining cash returns other than those returns agreed within the financial envelope (which is approved by both the Openreach board and the BT Group Board at a high level). This exposure to losses is not sufficient (alone) to indicate that BT has power over Openreach²⁷⁵.
- Ability to use power to influence returns
 - i. BT's influence would be materially stripped back by Ofcom's Proposals as described in paras. 82 to 84 below. In BT's view Openreach, being artificially constrained to consider only its own returns and to take no account of the downstream interests of BT, would be obliged to assess investment cases on a basis that does not represent the best use of its shareholders' capital. Although BT has some degree of oversight and a right to refuse certain recommendations from Openreach, these rights are protective in nature. BT may have substantial investment proposals which have favourable financial metrics when Openreach is within or part of BT group, but which Openreach, as an independent company,

²⁷⁴ BT notes that the terms of Art. 3(2) FD require the Member States to guarantee the independence of NRAs 'by ensuring that they are legally distinct from and functionally independent' of all communications and network providers, and also requires 'effective structural separation of the regulatory function from activities associated with ownership or control'. BT is concerned that Ofcom's Proposal would appear to infringe this requirement in so far as it envisages Ofcom exercising a significant degree of control over the governance of Openreach.

²⁷⁵ [3<].

may regard as lower priority or unfavourable investments. As such, BT may be unable to pursue significant planned investment projects.

82. It is clear from the statements in Ofcom's Proposals that it is the intention that BT should cease to have the current ability to direct the activities of Openreach. For example:
- "Openreach's strategic and operational decisions must be taken in a manner that does not favour BT's own retail business"(4.29) – so, in clear terms, Ofcom states that Openreach cannot promote the success of BT (4.29) as a whole;
 - "the [Openreach] directors would also have the statutory duties ... to promote the success of Openreach" (4.32) – so, Ofcom states that Openreach must be myopic in having regard only to Openreach (for an incorporated Openreach subsidiary of BT, as set out in Ofcom's proposal);
 - "once the financial envelope has been set, Openreach would independently develop its priorities in the interests of all its customers" – so it is not for BT but for Openreach to determine its priorities (4.45); and
 - "BT Group does not need to have direct control over any of the decisions made by Openreach within this budget, as these are decisions of the Openreach board" (4.50, emphasis added).
83. This degree of independence is not remedied by any other means. There are to be no direct reporting lines from Openreach executives to BT (see 4.27). The BT appointee cannot undermine the independence of the Openreach board (see 4.34). BT cannot use its power to appoint NEDs to undermine the independence of the board. "Clearly, we would be concerned were BT to use this control [referring to the powers to appoint and remove directors] in a way that undermined the independence of the Openreach board" (4.25).
84. BT cannot use its power to set the high level envelope for Openreach to undermine the independence of Openreach: "Once the financial envelope has been set, Openreach would independently develop its priorities in the interests of all its customers" (4.45) – so, in clear terms, Ofcom states it is not for BT but for Openreach to determine its priorities. Only "a high level summary of the key elements of the each plan would be shared with the BT Group Board" (4.48).
85. And if BT somehow finds an unidentified mechanism to exert BT influence over Openreach decisions, then structural separation is held out as the ultimate threat (see 6.5 or 6.20 for example).

4.9.1.2 Company law constraints

86. The directors of BT Group plc owe fiduciary duties to BT Group plc and are required by statute to promote the success of the company. This translates into acting in the interests of the shareholders of BT Group plc. If BT Group plc is not able to maintain appropriate control of Openreach, which represents approximately 40% of the Group's total EBITDA and 59% of the tangible fixed assets²⁷⁶ on the Group's balance sheet it is hard to see how the directors are able to comply with these duties. [X] virtual structural separation of Openreach (which Ofcom has no power to impose on BT) and there are a number of other aspects that the directors of BT Group plc are unlikely to be able to agree to whilst fulfilling these statutory duties. These include the ceding of control of, the operation of Openreach without an overriding right to operate it for the benefit of BT, the need to comply with the UKLA listing rules and of incurring costs disproportionate to the benefits Ofcom is seeking.
87. Furthermore, if the transfer of assets to an incorporated Openreach was classified as a Class 1 transaction under the UKLA Listing Rules, as appears likely then BT Group plc would need to seek shareholder approval by sending a circular to shareholders and convening a meeting before it could proceed. BT could not agree to Ofcom's Preferred Model without shareholder approval. The circular would need to contain certain prescribed financial and other information and would need to be approved by the UKLA. BT does not believe that the shareholders would be willing to agree to such a transaction, which offers no benefits.

4.9.1.3 UK Listing Authority rules

88. The degree of independence Ofcom is seeking for Openreach under the Ofcom Proposals may have the effect that, under the Listing Rules, either:
- i. BT was deemed to no longer be able to carry out its business independently (LR 9.2.2A); or
 - ii. the arrangements were such that they may change a shareholder's economic interest in the company's assets or liabilities.
89. If BT was deemed no longer to carry on its business independently, because a substantial proportion of its assets and cash-flows were in fact managed by a board outside their control – the Openreach board – then this may threaten its eligibility to remain a listed company. [X

²⁷⁶ As at 31 March 2016.

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90. In short, an adverse consequence of Ofcom's Proposals [3<]. No benefits for any party arise from this impact, only harmful impacts, for end-customers, CP-customers, shareholders, debt-holders, pensioners or employees.

4.9.1.4 Access of information to comply with DTR and MAR

91. As a listed company, BT has the obligation to disclose to the public all Inside Information as soon as possible, subject to certain circumstances where delayed disclosure is permitted. The assessment of the nature of the information and potential required disclosure is an on-going process which requires expert appraisal and whose ultimate responsibility lies with the senior executives of a company (particularly the CEO and the CFO). Under Ofcom's Proposals, there would be no direct line between Openreach executives and BT Group executives but only a board to board line of reporting, on a quarterly basis. There is, as a result, a real risk that BT may not be allowed to adequately monitor and disclose Insider Information relating to Openreach²⁷⁷.

4.9.1.5 UK Corporate Governance Code

92. The Financial Reporting Council has set out its code for good corporate governance. The tenet of that Code is built on the notion of control following ownership. This is to ensure that directors have the right tool kit to be good stewards of the company for the benefit of shareholders. For example, the board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles. This will be extremely challenging – if not impossible – if Ofcom's Proposals are adopted.
93. Equally, the Code states that the company should be headed by an effective board which is collectively responsible for the long-term success of the company. Among other things, an effective board provides direction for management and makes well-informed and high-quality decisions based on a clear line of sight into the business. One can fairly query whether BT Group plc board would be an "effective board" with regards to the Openreach business, if it cannot direct Openreach management and does not have a clear line of sight into the business. The board should also be responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives. It is important that executives with the relevant understanding and skillset are involved in this decision making and risk assessment. Clearly the Ofcom vision for the division of ownership and control falls outside that notion of good governance.

²⁷⁷ [3<].

4.9.2 Incorporation of Openreach

94. Section 5 of Ofcom’s July Consultation is intended to consider “the potential costs of implementing our proposal, and the likely impact of those costs”. This section, however, is only eight pages long and does not contain any detailed analysis of costs and other implications; rather, it simply outlines the types of cost that Ofcom believes may arise without making any attempt to measure or quantify them.
95. In para. 5.2, Ofcom states that “We have designed our model to ensure that the costs are proportionate”, but then in effect acknowledges that the costs may be disproportionate in a number of key areas, acknowledging that:
- i. BT pensions are a key consideration and that the impact of its proposal will depend on the Trustees’ assessment of the risks facing the scheme. It realises that “*some aspects of our proposal, such as the incorporation of Openreach and the transfer of assets and people, could increase the Trustees’ assessment of these risks*” (para. 5.5). It acknowledges that in the absence of sufficient mitigation, pensions changes could incur “*significant costs disproportionate to the benefits from any intervention*” (para. 5.7);
 - ii. Transfers of employees to an incorporated Openreach or the hiring of new staff were likely to trigger significant costs (paras. 5.27 to 5.32);
 - iii. Specific asset transfers and negotiating new contracts could raise significant costs or practical challenges (para. 5.38); or
 - iv. Significant tax costs could be incurred in the transfer of property and other assets (para. 5.44).
96. Further, Ofcom goes on to propose a number of “mitigations” in the event that these costs prove disproportionate (together the “**Ofcom Alternative Model**”), acknowledging that:
- i. the “transfer of non-network assets may be less critical, for example, property and fleet; these could be accessed based on supply agreements”,²⁷⁸
 - ii. “in the event that employee transfers were likely, however, to trigger significant costs”, it “would consider alternatives such as employee service agreements”,²⁷⁹

²⁷⁸ Para. 4.78, July Consultation.

²⁷⁹ Para. 5.32, July Consultation.

- iii. BT's obligations to the BT Pension Scheme rely on Openreach's net assets and profitability and Ofcom proposes a number of possible mitigation mechanisms;²⁸⁰
 - iv. with respect to contracts with customers and suppliers, "there may be a possibility of seeking consent to include Openreach in existing agreements where possible";²⁸¹
 - v. with respect to wayleaves it "would consider alternative options to specific assets transfers if it was shown to raise significant costs or practical challenges";²⁸² and
 - vi. "while full physical separation of IT systems could provide an additional layer of protection, the associated costs are unlikely to be proportionate; we therefore envisage that the existing separation of systems would be sufficient".²⁸³
97. It is striking that Ofcom does not attempt to measure or quantify these costs, notwithstanding the fact that BT has previously supplied it with a range of costs on various separation models. Many of these costs are underestimated as "one-off" management or process costs rather than an ongoing or long term liability. Ofcom refers in para. 5.47 to estimates of costs that would be incurred under different models of separation provided confidentially by BT, but dismisses them in para. 5.48 on the grounds that they are not specific to the model set out in Ofcom's document and that they do not include the mitigations, particularly for pensions. BT submits with this Response an updated version of the estimates of costs, initially provided on a confidential basis, which shows the true estimated costs of the Ofcom's Proposals.²⁸⁴
98. In this Section 4.9.2, we set out the short-term and longer-term implications for BT and its workforce of incorporating Openreach, including:
- i. A detailed quantified assessment of the costs outlined by Ofcom;
 - ii. Substantial costs which are missing from Ofcom's analysis; and
 - iii. Broader challenges including issues of compatibility with company legislation and accounting standards.
99. Much of this information has already been provided to Ofcom in response to formal information requests issued by Ofcom under s. 135 CA03 and in

²⁸⁰ Para. 5.21, July Consultation.

²⁸¹ Para. 5.37, July Consultation.

²⁸² Para. 5.38, July Consultation.

²⁸³ Para. 5.41, July Consultation.

²⁸⁴ p.14 et seq., KPMG Impact Report.

presentations from BT's advisers. It is disappointing that this evidence has been ignored without reason.

100. KPMG carried out a due diligence exercise on the basis of estimates provided by BT's internal experts (except the pension costs which are KPMG's estimates), set out in the KPMG Impact Report. That report estimates that the proposed Ofcom scenario, should the most extreme key elements of governance mentioned by Ofcom in its Preferred Model be implemented [redacted]

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101. KPMG has also diligenced BT's analysis of the mitigations offered by Ofcom in the Alternative Model but a partial asset transfer would trigger TUPE requirements (with knock-on effects on BT employer covenant and pension). BT estimates that the costs would still remain disproportionate, notwithstanding Ofcom's mitigation, adding one-off costs of [redacted] and c. [redacted] of ongoing annual incremental costs.
102. BT's analysis of the pensions implications of Ofcom's Proposals is supported both by the PwC Pensions Report, and diligence by the KPMG Impact Report. The analysis of the broader complexities associated with Ofcom's Proposals is supported by the further reports annexed to this response.

4.9.2.1 Pensions costs and implications²⁸⁵

103. The BT Pension Scheme ("**BTPS**") is a very material scheme both in terms of absolute size and in comparison to that of the company. Its impact on BT is of a very long term nature and is subject to challenging and fluctuating market conditions and political climate. By way of background context:
- *Size of scheme* - The BTPS is the largest private sector scheme in the UK with more than 300,000 members of whom c.34,000 are employees still accruing benefits. As at June 2016, the BTPS had total assets worth £46 billion;
 - *Funding position* - As at June 2014, there was a £7 billion deficit in the BTPS, which BT and the Trustee agreed would be met over a 16 year period. The deficit has increased substantially since then due to market conditions, with the Trustee's latest annual funding update at 30 June 2015 showing a deficit of c. £10bn;
 - *Employer covenant period* – The BT employer covenant concerns the legal obligation, ability and willingness of relevant employers to support and fund the BTPS. BT's pension promises are long-term in nature and

²⁸⁵ This report has been prepared independently from, and without input from, the BT Pension Scheme Trustee.

the BTPS will continue to require employer support over a very long period, with benefit cashflows projected to continue for over 70 years;

- *Political climate* - There have been several recent high profile cases where the judgment and decisions of pension trustees have, in hindsight, come under considerable scrutiny, for example, most recently, in relation to BHS and Tata Steel; and
- *Legislative context* - The Trustee has unilateral responsibility for setting the BTPS's investment strategy, after consultation with BT.

104. On the basis of the above, it can be seen that even a small change in BT's employer covenant can have a very significant impact on future pension costs for BT. As Ofcom notes in the July Consultation²⁸⁶, the actual covenant impact of Ofcom's proposals and related pensions costs are ultimately a matter of judgment for the BTPS Trustee. Ofcom also acknowledges that the Trustee is likely to be cautious in relation to any movement from the status quo.²⁸⁷
105. As Ofcom also acknowledges, pension costs have the potential to be the most significant cost item resulting from Ofcom's Preferred Model,²⁸⁸ entailing the following significant and wide ranging negative impacts on BT and its employees:
- i. Substantially weakening BT's employer covenant leading to a higher pension scheme deficit;
 - ii. Ofcom's proposed monitoring controls will lead to increased future regulatory uncertainty [§<]; and
 - iii. Significant Crown Guarantee issues which, absent the introduction of new primary legislation, would result in Openreach Ltd employees losing Crown Guarantee protection in relation to future service accrual²⁸⁹. These would present great concern to both the Trustee and BT's employees and Trade Unions, that would take years to resolve.
106. A more detailed explanation of these considerable disadvantages and their anticipated costs is set out below. Specialist covenant advisers at both KPMG and PwC have each independently advised BT that Ofcom's Proposals, even after taking into account the 'mitigations' suggested in Ofcom's Alternative Model, would likely lead to a substantial BTPS deficit increase which, taking into account the assessment of both advisers, would be at least [§<] and potentially [§<]. As such figures are based on the specialist covenant advisers'

²⁸⁶ Para. 5.15, July Consultation.

²⁸⁷ Para. 5.18, July Consultation.

²⁸⁸ Para. 5.3, July Consultation.

²⁸⁹ The Crown Guarantee is in effect a promise which was given by the Government on privatisation to stand behind the obligations of BT plc to the Scheme in the unlikely event of BT's insolvency.

assessments as to how the BTPS Trustee is likely to exercise its judgment on a model which is not defined in detail, the range is inevitably a broad one and the actual deficit increase is likely to lie somewhere in between. Further, BT considers, having regard to the specialists' advice, that many of Ofcom's mitigations are impractical. Without the mitigations and greater certainty over the long term regulatory framework, Ofcom's Preferred Model would increase the deficit further by between [x] and [x].[x]

].

107. For example:

i. a 16 year Recovery Plan met through level flat deficit payments would need c. £750m per annum to meet the c. £10bn deficit disclosed in the Trustee's latest annual funding update at 30 June 2015 (allowing for discounting on the future deficit payments);

ii. [x]

];

iii. [x]

];

108. Such increases in costs are hugely disproportionate and could threaten Ofcom's wider strategic objectives. At that level, they could adversely impact BT's credit rating and cost of capital and thereby threaten the availability of future financing and divert funds away from investment opportunities in UK telecoms infrastructure. That outcome would be directly contrary to Ofcom's stated objectives of the Strategic Review and would be contrary to its regulatory obligations and principles in the ERF and CA03.

Covenant Impact

109. As referred to above, the employer covenant concerns the legal obligation, ability and willingness of relevant employers to support and fund the BTPS. The Trustee currently has direct recourse to the Openreach business within BT plc; it places significant value on such direct access because the Openreach business provides long-term revenue and cash-flow streams for BT, underpinned by valuable infrastructure assets. In Ofcom's Preferred Model, where Openreach would become a separate incorporated subsidiary of BT plc and the relevant assets and employees would transfer to that subsidiary, this access would be subordinated from BT plc. This is problematic from a covenant perspective, particularly given the size of the BTPS. Ofcom's preferred fully incorporated Openreach compromises direct access to Openreach's assets and cash-flows, negatively impacting the employer covenant and increasing the risk to the pension scheme.

110. Ofcom has suggested various ‘mitigations’ to offset some of the resulting damage to the Trustee’s legal/structural access to Openreach²⁹⁰. These include:

- i. Openreach Ltd providing the BTPS with a guarantee that on BT plc insolvency Openreach Ltd would provide a priority charge over Openreach’s assets; and
- ii. Openreach Ltd providing a negative pledge constraining its actions.

111. KPMG and PwC have both provided clear and firm advice to BT that the mitigations suggested by Ofcom fall materially short of mitigating the entire covenant impact, meaning that disproportionate pension costs would still arise for BT (see KPMG Pensions Paper at section 6 and PwC Pensions Report at p.4 et seq.). In summary:

- i. The Covenant is not just concerned with legal/structural access to value. It also encompasses the employer’s financial ability to fund the scheme both now and in the long term future. The advice provided to BT by both KPMG and PwC considers that Ofcom’s proposals would likely hamper BT’s ability to raise future funding in the debt and equity markets;
- ii. The mitigations proposed by Ofcom would not fully reinstate the BTPS’s existing legal/structural access to Openreach’s assets. Even if, theoretically, the suggested Openreach guarantee was extended further in an attempt to ‘recreate’ the current position (in which Openreach is effectively liable for the entire liability in the BTPS and, on an ongoing basis, made deficit repair contributions in respect of its ‘fair’ share of historic BTPS liabilities), a contractual claim is still weaker than direct access to Openreach assets as it is subject to a greater degree of potential erosion, e.g. from future legal challenge or subordination;
- iii. There would be increased uncertainty and less flexibility relating to the BTPS’s access to the entire cashflow pool within BT;
- iv. The Trustee would need to negotiate with either two boards (i.e. BT plc and Openreach Ltd), instead of one, with the potential for each board to have divergent objectives, or with a BT plc which no longer had day-to-day control over a substantial portion of the assets driving the ongoing financial support; and
- v. Longer-term covenant risk would be materially increased if Ofcom’s proposed regulatory monitoring and review framework was implemented, resulting in significant regulatory uncertainty, [X

].

²⁹⁰ Para. 5.21, July Consultation.

112. The covenant impact would be even worse under Ofcom's Preferred Model without the mitigations being implemented and without other 'deal breaker' covenant issues [X
] being resolved. The advice BT has received from both KPMG and PwC suggests that in this scenario the Trustee might feel obliged to drive the deficit more towards a self-sufficiency funding level. That would result in a deficit increase of between [X

];

113. However, implementing the mitigations would be complex, lengthy and challenging to achieve in practice, would need, in substance, to restore the status quo position in terms of (a) the BTPS's access to the assets and cashflow of Openreach and (b) BT's control of Openreach, contrary to Ofcom's stated objectives of the Strategic Review. This would also be contrary to its regulatory obligations and principles in the ERF and CA03.
114. Further, implementation of the mitigations could result in unintended consequences, e.g. providing a charge over Openreach's assets may adversely impact BT's ability to raise financing for investments in future.

Crown Guarantee Impact

115. The Crown Guarantee remains an additional significant hurdle in relation to Ofcom's Proposals and one that is insurmountable in the short to medium-term. This is because, as Ofcom acknowledges,²⁹¹ any benefits accrued in a separately incorporated Openreach would not be covered by the Crown Guarantee. The Crown Guarantee is regarded as a valuable protection for members; the loss of Crown Guarantee coverage would be a major employee relations issue for BT and of significant concern to BT's Trade Unions.
116. The Trustee would also be concerned, both from a covenant perspective and also due to the potential impact on members. Should employees of a new Openreach Ltd remain members of the BTPS for future service, then Openreach Ltd would need to seek to be formally admitted as a participating employer. This would require Trustee consent. Given that any monies paid by Government under the Crown Guarantee in the unlikely event of BT's insolvency would be an asset of the BTPS as a whole, such further accrual by Openreach Ltd employees would have a dilutory impact on the Crown Guarantee for all members, not only Openreach Ltd employees. The Trustee has a legitimate interest in avoiding any material dilution of the Crown Guarantee in respect of past service benefits. It would therefore be challenging for the Trustee to proceed on this basis.
117. Openreach Ltd employees losing Crown Guarantee protection in relation to future service accrual would be a significant employee relations issue. Ofcom has stated that it does not intend to affect the benefits or protections for any

²⁹¹ Para. 5.26, July Consultation.

BTPS members and it is “*working with Government to consider further the implications of their proposals for the Crown Guarantee*”.²⁹² We understand that Ofcom envisages the Crown Guarantee being extended to cover accrual with Openreach Ltd. The Trustee could not rely on assurances made by Government in this regard in the intervening period as they would not be binding and any extension of the Crown Guarantee would need an Act of Parliament in any event, which would likely cause delay of several years. In any case, we have received no indication that Government would be willing to extend the Crown Guarantee in this way. Further and most importantly, primary legislation would not solve the material covenant issues.

118. Ofcom has suggested that an alternative approach to maintain Crown Guarantee protection for Openreach employees would be that Openreach employees who are BTPS members would not transfer to Openreach Ltd, but work entirely within Openreach under an employee service agreement.²⁹³ However, this model does not work because automatic TUPE transfers would be triggered if the Ofcom Preferred Model or the Alternative Model (e.g. excluding non-material assets) were implemented (see the employment section for further detail).
119. In conclusion, it is clear that very substantial costs and other significant issues relating to pensions would inevitably be caused by implementation of Ofcom’s Preferred Model. Even with the various mitigations suggested by Ofcom in its Alternative Model, the costs and disruption caused by its proposal would not be (i) proportionate and (ii) justified in light of the wider objectives required by Article 8 of the Framework Directive and Article 8(4) of the Access Directive.
120. In contrast, KPMG and PwC have both advised that BT’s proposal, which we consider is a comprehensive, effective and proportionate solution to the issues raised by Ofcom, should not lead to a material impact on BT’s employer covenant, whilst noting the importance of Ofcom providing greater certainty over the long-term regulatory framework. In addition there would be no Crown Guarantee issues arising under BT’s Proposal.

²⁹² Para. 5.26, July Consultation.

²⁹³ Para. 5.24, July Consultation.

4.9.2.2 Other Employment Costs: Compliance with transfer of employment legislation

121. As part of its Preferred Model, Ofcom has indicated that²⁹⁴:
- i. Employees working in Openreach should be employees of Openreach Ltd. rather than of BT Plc;
 - ii. Openreach Ltd should own and operate those assets Openreach already controls - namely the underlying infrastructure associated with the current Openreach network; and
 - iii. there would be a potential change from BT Plc to Openreach Ltd as the contracting party with customers.²⁹⁵
122. The Ofcom Preferred Model would trigger a transfer of employees under the Transfer of Undertakings (Protection of Employment) Regulations (“**TUPE**”). Even under the Ofcom Alternative Model (e.g. non-material assets do not transfer), the ownership and operation of those assets critical to the Openreach Board discharging its duties would transfer to Openreach Ltd. Further alternatives to an asset transfer are also raised, however, those alternatives still entail operational control transferring to Openreach Ltd²⁹⁶. This means that the Alternative Model and its variations would still very likely trigger TUPE.
123. A TUPE transfer would result in the automatic transfer of the majority of employees who work in Openreach into that new company (“Openreach Ltd”) (Regulation 4). In turn, that would trigger the following risks/costs which cannot be materially mitigated:
- i. A transfer of assets and people also would give rise to material pension costs (see pensions section above) which in turn would undermine BT’s ability to invest in broadband infrastructure and further improve customer service;
 - ii. One-off costs of a large scale TUPE transfer (administrative costs and management time);
 - iii. Employee and industrial relations consequences; and
 - iv. Incremental employment-related costs of running a separate subsidiary (e.g. losing economies of scale).

²⁹⁴ Para. 1.24(vii), July Consultation.

²⁹⁵ Para. 5.33, July Consultation.

²⁹⁶ Para. 4.80, July Consultation.

One-off TUPE Administrative and Management Costs

124. A TUPE transfer on this scale, involving over 31,000 people, will create material complexity and cost for BT.²⁹⁷ A transfer of this size would be one of the most significant ever.
125. The TUPE process would require a diligence exercise, for example to identify which employees were “in-scope” to TUPE (to be in-scope, an employee must be assigned to the transferring business: assigned is not defined in TUPE and would involve a factual analysis including multiple factors such as which cost centre the employee is charged to or the key focus of individual roles) (Regulation 4(1)). TUPE would then require an information and consultation process to take place with affected employees’ representatives (Regulations 13-14). We estimate this exercise along with any information and consultation process would take between six and twelve months. The obligation is to inform and consult about the fact that there will be a transfer and any “measures” that are envisaged. Measures means ‘legal, economic and social implications’ of the transfer on the employees affected. It covers a wide range of subjects such as pension, policies and processes and is not limited to contractual rights. The process is necessary not only to mitigate the impact on service, but also to mitigate against claims by employees and their representatives. Failure to comply allows employee representatives to make a claim for a protective award under regulation 15 of TUPE. The penalty is an award of up to 90 days’ pay per affected employee. In the case of Openreach, one quarter of the annual salary bill would be approx. [£]. It would therefore be important for BT to invest the time and resources as outlined below to manage this process.
126. There is a direct financial cost to BT. KPMG have diligenced our assessment of costs, based on recent experience with EE and other TUPE programmes. One-off costs would be likely to be in the region of [£]. This would be cover TUPE consultation and administration, employee records transfer and dealing with the impact of change and uncertainty from an employee perspective (e.g. higher absence / turnover). This would involve regular communication with employees, requiring some time away from day-to-day duties which would need to be mitigated through additional resource or overtime.
127. Ofcom outlines various suggestions in its Alternative Model²⁹⁸ which it says could mitigate the pensions and employment costs of a TUPE transfer. While it is not clear from the proposal what exactly Ofcom has in mind, or how any alternative to TUPE would operate in practice, BT has been able to extract the following principles:

Proposal 1 - Members of the BTPS could simply not transfer under TUPE; and/or

²⁹⁷ TUPE transfers are not recorded centrally. However, the Workplace and Employee Relations Survey 2011 estimated that there were 910,000 employees who transferred under TUPE in 2009 – 2011, across approximately 31,000 workplaces. This suggests an average transfer of 29 employees.

²⁹⁸ Paras. 5.16, 5.24 and 5.32, July Consultation.

Proposal 2 - TUPE could be avoided by using an “employee service agreement”.

128. However, when properly viewed against the background and objectives of the TUPE legislation, these suggested mitigations will not relieve the pensions and employment costs associated with the transfer of assets and /or employees²⁹⁹.
129. The purpose of TUPE is to protect employees’ rights on the transfer of a business with the result that their employment will automatically move to the new company if they are “in-scope”. It is not a matter of choice for BT, Openreach, Ofcom or indeed the Trade Unions to decide if a “relevant transfer” has happened for the purpose of the TUPE legislation. It is a question of law (i.e. the courts decide) whether TUPE applies. TUPE is triggered automatically if the legal test for a “relevant transfer” is met (Regulation 3). This means either:
- i. Transfer of an economic entity: the business or “undertaking” transfers to a different company. This involves moving the resources required in order to allow the business to continue operating (or pursue its “economic activity”). This most commonly involves moving the assets, customers and goodwill (Regulation 3(1)(a)); or
 - ii. Transfer of an activity: there is a “service provision change” (e.g. insource, outsource or a change in supplier) (Regulation 3(1)(b)).
130. If BT implemented either the Ofcom Preferred or the Alternative Model and moved the Openreach resources into Openreach Ltd it would amount to the transfer of an economic entity (or “business transfer”) and TUPE would be triggered.
131. Similarly, it is not open to BT, Openreach Ltd, Ofcom or the Trade Unions to pick and choose which employees are “in-scope” to transfer. It is a question of law whether a particular employee transfers, based on whether they are aligned to (or “assigned”) to the part of the business moving out (Regulation 4(1)). This is determined by looking at factors such as the percentage of time spent doing Openreach work.
132. Although some employers have attempted to avoid TUPE through various employment models, these attempts have not been successful when challenged in court and attempts at avoidance or circumvention are heavily criticised. TUPE precludes any contracting out of employees rights or employer’s obligations towards them (Regulations 4, 7 and 18) It would not be rational to expect BT to adopt a model that has been criticised by the courts already or which is untested. Both of the proposals suggested by Ofcom present an unacceptable level of legal risk.”

²⁹⁹ [3<

133. **As to Proposal 1:** The TUPE provisions do not determine which employees are assigned by reference to their membership of a pension scheme. If they are assigned to the business, they transfer automatically as a consequence of the relevant transfer regardless of the pension scheme in which they participate. It is not possible to cherry pick only those employees who are not members of the BTPS.³⁰⁰
134. Such an approach is also likely to be seen as divisive by employees, leading to challenge by employees and the Trade Unions. [X
].
135. **As to Proposal 2:** It is not clear what Ofcom means by an “employee service agreement” or how this could “contract out” or otherwise override TUPE. As set out above attempts to avoid TUPE have been heavily criticised in the past.³⁰¹

Wider employment relations consequences

136. For the reasons outlined above, a TUPE transfer would lead to covenant and associated funding impacts for the BTPS. It is unavoidable that material concerns for employees in a TUPE transfer will be their pension rights and long term job security. Beyond legal compliance with TUPE, there would be a desire from employees for reassurance on key employment matters. Employees would expect BT and their Trade Union representatives to protect their interests and challenge changes they consider detrimental. The Trade Unions would be obligated to their members to seek assurances on the future of any separated organisation.
137. The two Trade Unions who represent the majority of employees in Openreach (Prospect and the Communication Workers Union or “CWU”, the “**Trade Unions**”) have both set out similar concerns to those raised by BT during the consultation process. These were summarised in communications to their members in September 2016, and we understand they have made representations directly to Ofcom.
138. In their response to Ofcom’s proposal, the Trade Unions have said that they are concerned that their members would be unable to continue in active membership of the BTPS and that any attempt to cease active membership of the BTPS would create “*irresistible pressure for a major industrial dispute (which in itself would have significant implications for the covenant as well as for customer service)*”.³⁰²
139. Both Trade Unions have said they share the ambition of Ofcom to bring about a fundamental improvement in customer service and that this is likely to involve

³⁰⁰ [X

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³⁰¹ [X

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³⁰² Para. 4 of CWU/Prospect Response 16 September 2016.

some hard issues for the unions and employees. However, the “*combined potential impact of a TUPE transfer and collateral damage to pensions*” would make it “*impossible*” for them to persuade their members of the need for change.³⁰³

140. The CWU (who represents the largest group of employees in Openreach) set a union policy at their April 2016 conference to “*oppose by all means necessary including Industrial Action any attempts to sell off or turn Openreach into a BT subsidiary*”. Prospect have confirmed they will take the same position. Industrial action by the unions is likely to damage customer service.
141. The uncertainties and concerns associated with implementing the Ofcom Preferred or Alternative Model would impact on employee engagement that in turn would impact on the customer experience and service levels. There may also be an impact on Superfast Broadband rollout or FTTC/FTTP. Openreach needs to continue to invest to improve service, including further changes to working practices. A climate of concern from employees associated with a TUPE transfer, including any form of industrial action is likely to be destabilising and damaging from a customer service perspective, even with actions by BT to mitigate against disruption.
142. In contrast, as set out in Section 5, BT’s Proposal brings further investment to improve service levels. Some aspects of these service improvements will require change and further flexibility from employees; the BT unions recognise this and have put their support on record: “*We confirm a clear and unambiguous offer that both unions will commit to accelerate discussions with BT designed to further enhance a new, different and better culture and approach in Openreach, dedicated to ensuring a better customer experience. This must be predicated on an outcome that there is no TUPE or damage to the BT covenant.*” (See section 3 of their submission to Ofcom September 2016).

Incremental costs of running a separate subsidiary

143. BT would also incur the incremental costs of running a separate subsidiary. The employment costs would amount to [x] per annum.

Building Openreach capability; culture and ways of working

144. Ofcom’s July Consultation makes a number of references to the culture of Openreach. BT’s view is that organisational culture is very significant, and have highlighted below some key aspects of the Openreach organisation, culture and ways of working that we believe support many of the aims of the DCR and would be enhanced further through adoption of BT’s proposal.
145. Openreach already has its own, distinct culture that is different to the rest of BT. This difference is in part a recognition that many of the types of work undertaken in Openreach (e.g. external field engineering) are predominantly undertaken only in Openreach, but also reflects that considerable investment

³⁰³ Para. 4 of CWU/Prospect Response 16 September 2016

has been made to embed equal access and functional separation over the last 11 years. This investment has been continuous in systems, process and training that have fully established ways of serving customers that are agnostic of CPs.

146. Openreach has recruited extensively since its creation, with over 20,000 people joining the organisation. Given this growth activity, movement of people from Openreach to the rest of the Group has been very modest, with less than 6% having moved out to other roles in Group during the 11 years.
147. In addition, Openreach has its own Headquarters building and distinct internal and external branding that is different to the rest of BT. Organisationally it has its own capabilities in Finance, Strategy, Product Management, CIO, Regulation, HR, Learning and Development, Communications, Legal and Equivalence. BT's proposals bring greater clarity and autonomy for Openreach across many of these HQ functions.
148. There is an increasing emphasis on quality throughout the organisation, improving service and effectiveness for the long term. Recent changes include bringing clearer accountability in Ethernet delivery, insourcing some aspects of civil engineering work and substantial investment in tools and testing technology.
149. From a job design perspective Openreach has introduced new employment terms and conditions for new hires with pay arrangements that are different to rest of BT and appropriate to the work people do. Whilst acknowledging there is still more to do, working practices such as end-of-day working have become more flexible, along with changes to attendance pattern to improve service. Managerial and Executive bonus arrangements reflect Openreach, not BT Group performance or BT's share price.
150. BT would welcome an opportunity to discuss how the Openreach culture will develop further through adopting BT's proposals.

4.9.2.3 Transfer Costs for Assets and Contracts

Network assets

151. In the July Consultation, Ofcom says (para. 1.24): "Openreach assets. Our starting position is that Openreach should own those assets it already controls, namely the underlying infrastructure (such as underground ducts and telegraph poles) associated with the current Openreach network" and "these are the physical assets within BT's access network, and some transmission assets, mainly related to wholesale VULA product" (para. 4.78). In common with the general approach in its July Consultation, Ofcom has not provided a detailed analysis of the specifics, practicalities, costs and other implications of its preferred asset ownership model. Furthermore, Ofcom has not provided any assessment of whether the costs of implementing Ofcom's asset separation model are disproportionate to the aim of addressing a potential competition problem.

152. The network assets used to provide Openreach services cover a broad and substantive range of assets including physical network (passive) assets and electronics (active) assets. These assets extend beyond the physical access network and are in many cases shared assets - the duct, for example, which may be used to carry access, backhaul and core network cables, Ofcom specifically includes in their starting position. Also, in a number of substantive cases, active transmission assets necessary for the delivery of Openreach services are operationally owned and managed by other parts of BT. This is a requirement of the Undertakings and examples are Ethernet and Linecard electronics. Whilst Ofcom does not specifically mention these specific assets in their starting position for Openreach asset ownership, these are assets necessary for the delivery of Openreach services and are not owned or managed by Openreach today. Ofcom note in para. 4.78 the proposed inclusion of active wholesale VULA assets which are operationally owned by Openreach under a variation to the Undertakings although we note the omission from para. 4.78 of reference to the Ethernet and Linecard active assets necessary for the delivery of Openreach services.
153. The existence of i) shared assets and ii) assets necessary for the delivery of Openreach services that, under the provisions of the Undertakings, are not operationally owned by Openreach, creates substantive, extremely complex and costly financial, legal and operational separation issues and no clear benefits compared to the position in place today. As BT has not proposed a legal separation of Openreach assets - and in the absence of a more detailed analysis in Ofcom's July Consultation as to the assets Ofcom proposes to divide and how those assets would be divided - BT has not undertaken a detailed, costly and lengthy feasibility study for the separation of Openreach assets or a similarly complex, costly and lengthy due diligence review. Finally, as explained above, there are substantial consequential impacts - for example on pensions and employees - of separating Openreach assets.

Customer and supplier contracts

154. Although trading is the key constituent of an independent business, Ofcom remains particularly vague in its July Consultation as to whether Openreach would, in either of Ofcom's Preferred Model or Alternative Model, need to become the trading entity, either for the current contractual relationships or for its future relationships going forward after incorporation. Ofcom simply states that "there would potentially be the need to change the contracting party from BT plc to Openreach".³⁰⁴ It very simplistically offers as a mitigation the possibility of seeking consent to include Openreach in existing agreements where possible, which according to Ofcom would be a less onerous process than negotiating new contracts.³⁰⁵

³⁰⁴ Para. 5.33, July Consultation.

³⁰⁵ Para. 5.37, July Consultation.

Supplier Contracts

155. Currently nearly all supply agreements which Openreach relies on are entered into by BT plc. As such Openreach relies extensively on BT supply agreements which support BT's operations generally rather than just Openreach. Examples include IT systems, HR and group services, network equipment etc.
156. In the July Consultation, Ofcom recognises that there could be lost economies of scale in relation to future procurement contracts where they are negotiated with a smaller Openreach entity rather than the larger BT plc.³⁰⁶ BT's estimates (diligenced by KPMG) that procurement dis-synergies for Openreach would amount to [§<] p.a. and that procurement inefficiencies of [§<] would be expected³⁰⁷.
157. Besides the lost economies of scale, there are several areas where BT would encounter problems with its group-wide supply contracts:
- i. Some contracts, such as [§<], would not automatically extend to a new subsidiary such as Openreach and BT would be in default should Openreach carry on using supplies without further agreement from the suppliers;
 - ii. Some contracts are absolutely restricted to BT plc, BT plc being the trading company of the group;
 - iii. Other contracts contain termination rights in favour of the supplier where there is a change of control, which might be triggered depending on how the new Openreach subsidiary is set up. This issue is particularly problematic with Ofcom's proposed governance controls as it is not clear whether Openreach would qualify as a "subsidiary Undertaking" as defined in the 2006 Companies Act; and
 - iv. Other supply contracts only extend to subsidiaries of BT plc where BT has "effective control". Ofcom's proposed models are likely to be challenged by suppliers as they do not establish a subsidiary over which BT has control as envisaged in the contracts.
158. These problems will undoubtedly create opportunities for suppliers to demand a re-negotiation or fresh contracts which they will use to their advantage to extract higher fees. Based on past examples, the sums at stake here are very significant.
159. In addition, there would be an expensive and time-consuming contractual review and due diligence exercise that would be necessary if Openreach were established as a wholly-owned subsidiary and needed to benefit from BT's existing relevant contracts. This large and complex task would take several quarters to complete across the portfolio of supply contracts to determine which

³⁰⁶ Para. 5.35, July Consultation.

³⁰⁷ Slide 16, KPMG Impact Report.

agreements Openreach relies on and whether incorporation triggers any obligations to notify and/or seek the consent of suppliers or an amendment to the contracts. It is impossible to determine how long it would take then to renegotiate the contracts, given that this is dependent on the willingness of the counterparty to enter into discussions and resolve them on a reasonable basis as to terms and timeliness.

Customer Contracts

160. All of Openreach's customer contracts for the trading of Openreach's products and services are entered into by BT plc and each customer would have to be informed of the change in the contracting party to their contract. Such an exercise would be time consuming and costly as Openreach has a broad customer base of approximately 500 Communications Providers, many of which have signed up to more than one product contract.

Intellectual Property Rights

161. To operate its network assets, Openreach would need access to intellectual property rights (e.g. patents, copyrights, etc.) presently held by BT either as registered owner or licensee. BT's own intellectual property rights and indeed third party intellectual property rights would need to be licensed to Openreach on an arm's length basis. BT cannot compel third parties to agree to any such licence nor direct the price and terms that Openreach would be forced to pay. Again, we would need to undertake and complete a full due diligence exercise to give a definitive answer to the scale and likely costs of this process.

Wayleaves

162. Ofcom indicates in its July Consultation that it would consider alternative options to specific asset transfers if it was shown to raise significant costs or practical challenges. As shown below, any attempt at assigning wayleave agreements to Openreach would be complex, lengthy and costly to BT. Even if BT plc were to have recourse to an alternative such as simply granting Openreach the right to use the wayleaves, BT would face similar issues. BT uses a number of different types of wayleave agreements, which authorise it to install and maintain its equipment on land or premises owned by third parties. They date from many decades ago and there have been many different forms of agreement over the period.

Simple wayleave agreements

163. The two main types of "simple" wayleave agreements are:
- i. the A1000 series which is used when seeking permission to install and maintain our equipment across land owned by third parties, and
 - ii. the A5000 series which is typically used in buildings for providing services for tenants where permission is needed to place equipment in leased property or to enter the common parts of a property. There are between 1-2 million of these two types of wayleave agreements. Each

new wayleave within this framework is individually negotiated with the relevant grantor which means that the standard format terms are frequently varied with the consequence that some terms are diverse. Some contain express rights of assignment, some are silent as to assignment and others may contain prohibitions on assignment or require consent. Further due diligence on a wayleave by wayleave basis would be required to establish the true scale and costs of the transfer process. Given the very large number of wayleaves, it would be a huge logistical and costly exercise to check each wayleave agreement and seek individual grantor consent where required.

164. Ofcom refers specifically to the A1000 series contract which contains a clause whereby the BT contracting party includes “anyone who takes over our business and our contractors”. However such clause would only apply in the event of a transfer of the whole of BT’s business (BT plc being the contracting party) and not just the Openreach business (Openreach not having separate legal entity from BT plc). As a result, BT would not be able to simply rely on this clause and notify the landowners as Ofcom suggests.
165. One possibility might be to assign the wayleaves to Openreach by means of a BT plc/Openreach “omnibus agreement” and then try to limit/manage the risk by handling all queries and disputes from wayleave grantors on an individual bi-lateral basis. However BT would expect a number of land agents and surveyor firms would take this opportunity to offer “wayleave re-negotiation” services to wayleave grantors generally, resulting in BT having to renegotiate a substantial number of agreements.
166. The majority of the wayleave agreements signed by BT over the last 10 years are evergreen, such that BT has rights to remain as long as the equipment is needed to provide service. However prior to that, agreements will have had a variety of termination clauses, meaning that it is possible that some of these will fall to be renegotiated in the next few years. It is possible that transfers of wayleave agreements from BT plc to Openreach will bring forward the opportunity for wayleave grantors to renegotiate their agreements, demanding better terms and increased charges.

Comprehensive Agreements

167. BT also has c. 32 “comprehensive agreements” that are specifically negotiated with large landowners such as the Crown Estate, the Church, Network Rail, British Ports Authorities and other bodies. Prior consent from the counter-parties will be required to assign those agreements to Openreach and the various bodies and authorities would be very likely to take this opportunity to renegotiate the terms of conditions and demand higher wayleave charges for themselves, or in the case of bodies such as the National Farmers Union, for their members.

Other Agreements

168. There are also different wayleave agreements for radio masts, sub-sea cables, joint user poles and other specific network assets. Their terms and conditions vary from one category to the other and further due diligence would be required to establish the true situation with respect to a potential assignment to Openreach.

Conclusion

169. Any attempt to obtain consent from any type of wayleave holders could very likely lead to a renegotiation of the relevant wayleave agreements or a request that new wayleave agreements are entered into (see below). The renegotiation of the very large number of individual wayleave agreements - which BT does not expect to be renegotiated in the ordinary course in the next few years - would be a very time-consuming exercise. Such an exercise could result in the other party seeking to terminate the wayleave (which could mean that we would need to resort to a legal process to grant us a new one) or demand higher wayleave payments, which would have potentially a substantial financial impact on Openreach depending on the number of wayleave agreements involved.
170. The position is further complicated by the new Electronic Communications Code (“**ECC**”) that is expected to be implemented in April 2017 following the passing of the Digital Economy Bill. The new ECC seeks to balance the rights of landowners and operators and in its current form will, for new agreements, pass the cost of moving telecommunications apparatus when land is developed from the landowner to the operator. If therefore BT has to negotiate new wayleave agreements after the implementation of the new ECC as a result of unauthorised transfers of existing agreements, BT would be exposed to an increased liability for the network re-arrangements under the new agreements. In its response to the ECC consultation in 2015, BT estimated that a retrospective application of the ECC would have led to [X] a year as costs of moving apparatus at the request of landowners, based on the costs that landowners pay on average in the normal course of business.
171. Any due diligence exercise on the scale of such a large number of contracts would necessarily be costly and time consuming and would need to take account of a wide number of potential variables, e.g. identifying who owns the land in each case, whether the wayleave was evergreen or not, the potential for protracted negotiations and even disputes in some cases. Inherited rights that are not explicitly contained in a defined wayleave agreement, such as with the London Docklands Development Corporation, which gave the entity that is now BT a number of inherited rights, would also need to be considered.
172. Many of our wayleaves are in hard copy form only and we do not have wayleaves for all our installed network, therefore in certain circumstances BT may need to rely on implied consents, potentially further complicating the exercise.

173. The issues raised above would also arise with any attempt at granting to Openreach Ltd rights of use of the wayleave with respect to the comprehensive agreements and all the other specific agreements for radio masts, sub-sea cables, joint user poles and the specific network assets.

Property

174. BT's UK property portfolio (excluding the properties of the recently acquired EE business) comprises approximately 6,350 properties, of which Openreach currently uses or occupies c. 6,100. Approximately 6,000 of BT's UK properties are subject to the 2001 sale and leaseback arrangement with Telereal Trillium (the "**Leaseback Arrangement**"). Of those properties, most are held on a freehold basis but around 850 are leasehold, leased by BT from third party "superior" landlords who sit above the Telereal leaseback structure.
175. Of the few properties outside the Leaseback Arrangement (c. 350), a few are freehold but most are held on conventional leases with third party landlords.
176. There are a number of restrictions on BT's ability to transfer/assign etc. its rights to occupy and use the property to another corporate entity within the BT Group.

Leaseback Arrangement properties

177. [X

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178. [X

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- i. [X

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ii. [X

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iii. [X

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iv. [X

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179. [X

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Conventional leases with third party landlords

180. For approx. 6% of all BT's UK properties, the landlords' consent for the majority of the properties will be needed for assignment of rights to occupy the properties and such consents will be subject to specific conditions (e.g. parent company guarantee). The exact number is subject to further due diligence.

Practicalities applicable to all leases

181. One of the major practical considerations would be the preparation of plans of sublet areas (either for the Openreach areas where BT would retain the leases or the BT retained areas in the event of assignment to Openreach) that would need to be adequate for Land Registry purposes. These would need to be properly surveyed and prepared. As each property would need to be visited and measured, the process would be very lengthy. Furthermore, it would need considerable input from the Group Property team / their external managers, as

instructions would need to be given for all of the buildings and then each plan would need to be checked. If a building currently had unused space, it would take time and effort (and there might be disagreements over how the space was to be allocated) to sort out who got that empty space.

182. In order to put in place subleases, it is likely that a degree of physical separation would need to be carried out where shared occupation occurs in a building. Sub-letting would also require some moves of staff and creation of new office areas within existing buildings. This could cost in the region of [X] for the creation of office space and if additional physical separation were required, alterations to fire detection systems, welfare areas and physical access systems would add a further cost of [X] depending upon the degree of works required.

Cost and time

183. BT estimates that for all properties where Openreach currently has some occupation in BT premises (c. 6,100 properties) a cost of [X], as diligenced and shown in KPMG Impact Report, would be borne by BT in relation to granting subleases to Openreach Ltd or BT plc as applicable on a property-by-property basis and physical separation. [X

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184. The time and resources required to negotiate and implement changes to the current BT real estate agreements should not be underestimated given the size and complexity of the portfolio, the number of inspections and surveys required and Telereal Trillium's and other third parties' consents process. A time frame of 36 – 48 months is a reasonable estimate.

Group Property and BT's Facility Management organisation

185. BT's own Facility Management organisation currently provides real estate advisory and FM services, project and maintenance services to the entire BT estate. For Openreach to act as a standalone entity under the proposed Ofcom Preferred Model, a new Real Estate and Facility Management system would be required by Openreach with a one off set up cost of c. [X] and an ongoing running cost of between [X] and [X] p.a. depending upon the level of independence required. Openreach would also potentially lose the efficiencies from having Facility Management services provided by BTFS and this is estimated to be c. [X] p.a. with one off transition costs of c. [X] for new supplier arrangements (these figures were not included in KPMG's diligence exercise).

Stamp Duties

186. Material amounts of stamp taxes could be payable on the establishment of Openreach Ltd if BT plc and Openreach do not meet the conditions for group relief. This is explained in more detail in paras. 199 et seq.

Sub-letting agreement

187. Where BT plc envisage sub-letting the properties to Openreach Ltd instead of assigning the leases, any sub-letting arrangement would be subject to substantially all the constraints listed above.

Ofcom Alternative Model

188. Ofcom recognises that the transfer of non-network assets (such as property) may be less critical to achieve the level of independence Ofcom is seeking for Openreach, and that if significant costs were to be incurred in the transfer of property assets, such assets could be accessed by Openreach on the basis of “supply agreements” instead.
189. Overall the *Specialised Estate* and *General Purpose Estate* can be made available to Openreach Limited by way of a group-sharing agreement without any specific consents required. However there will still be a need to survey Openreach space, in particular to agree who owns unused space and how the space is divided (as highlighted above for the Preferred Model).
190. As for the 850 or so Telereal properties held by BT under “*superior*” leases, a group-sharing agreement is likely to require the consent of a substantial number of the third party “superior” landlords. The exact number is subject to further due diligence. The situation is the same for the conventional leases with third party landlords. BT evaluates the overall cost of due diligence to be [£x] based on an assumed cost of [£x] per property.
191. It is unlikely that there would be any stamp tax implications on any group sharing arrangement but this would need to be subject to specialist advice on the proposed structure, particularly for those properties subject to the existing Leaseback Arrangement.

IT systems and processes

192. In its July Consultation (paras 5.39 to 5.41), Ofcom states that the existing separation of systems that BT has carried out under the Undertakings would generally be sufficient for its Preferred Model. If, however, Openreach was required to have completely separate systems, BT estimates that such separation would entail at least [£x] as additional one-off cost and annual ongoing costs of [£x] (see KPMG Impact Report). BT believes these estimates are consistent with the over £1 billion that BT has spent so far on meeting its Undertakings system separation obligations.

4.9.2.4 Tax implications

193. In its July Consultation (paras. 5.42 to 5.45), Ofcom concedes that a number of tax costs could be incurred if Openreach were set up as a legally separate subsidiary but does not attempt to quantify them, saying that their amount would depend on the nature and extent of assets transferred and Openreach's model of governance. It identifies stamp duty as the most significant but concludes that it is unlikely that BT will incur substantial corporation tax costs or a material change to its business rates.

Business Rates

194. Incorporating Openreach as a separate legal subsidiary, that is wholly owned by BT, may result in separate hereditaments being created by the Valuations Office for the BT and Openreach occupations and cumulo assessment.
195. There is no national settlement between BT and the Valuations Office in relation to business rates. Business rates are set by local authorities and are currently levied on BT's non-operational estate (offices, depots, warehouses) in the local list on the normal basis. Any of the assets which are transferred to a separate legal entity will result in the associated rating liability also transferring. This does not include the operational network infrastructure and associated land and buildings (telephone exchanges and data centres), which are assessed by the Valuations Office under the central list "cumulo" assessment.
196. The existing cumulo rating regime is based on a central list valuation determined by the Valuation Office for BT's network (ducts, cables and fibres and associated rateable plant and operational buildings such as telephone exchanges) for the entire UK. This is then apportioned between England, Wales, Scotland and Northern Ireland.
197. Under current legislation, the transfer of any rateable operational network infrastructure to Openreach as a wholly-owned subsidiary would require the removal of those assets from the central BT cumulo assessment and for them to be separately assessed. The Valuation Office Agency would need to revisit all of the rateable values for the network assets transferred. The "residual" BT cumulo assessment would also need to be re-assessed, including the assessment of potentially all the telephone exchange and specialist operational buildings. Unless an amendment were made to the relevant legislation, Openreach's assets would then need to be assessed within the local lists, rather than being assessed with the BT cumulo assessment in the central list. Such dual assessment would be a very significant task and will lead to an increase in the total rates payable.
198. In addition to potential increases in rates payable, the separation process itself is also certain to create considerable work and expense for BT. Openreach would need to evaluate, agree or appeal the rateable values set by the Valuation Office (potentially on a property by property basis), and this would require significant resource to work on this project including external specialist advisors and legal input. The cost of this could be c. [£] during the initial

assessment period and an ongoing cost of c.[£] p.a. in administration costs (these figures were not included in KPMG's diligence exercise).

Corporation Tax, Stamp Taxes and VAT

199. The establishment of Openreach Ltd as a separate legal company could give rise to both one-off and recurring tax and tax-related costs. Whether these will arise will depend on the application of detailed tax rules to the precise terms of Openreach's establishment. BT welcomes Ofcom's view that no material tax costs would arise from their Proposals. However, given the potentially significant costs involved, Ofcom should be seeking definitive assurances from HMRC before that view can be relied on. The level of tax and tax-related costs incurred is critical for assessing whether Ofcom's proposals are proportionate.
200. BT expects that Ofcom will seek from HMRC additional comfort that no corporation tax or stamp duty land tax would arise on the transactions to create Openreach, and that this would not accelerate the payment of historic deferred tax liabilities. HMRC should also give comfort that on an on-going basis BT and Openreach could form corporation tax group relief and VAT groups. Assuming such assurances are received, we assume that Ofcom would not object to these groups being formed, otherwise further incremental costs, such as systems development costs for VAT, would need to be included in the assessment of whether Ofcom's Proposals are proportionate.
201. BT is an innovative group with a significant patent portfolio generating significant benefits under the UK's patent box regime. A loss of these benefits would be pertinent when assessing if Ofcom's Proposals are proportionate. We would expect that if Openreach is established in an appropriate manner these benefits could be maintained and, consequently, Ofcom should confirm its support for achieving this as an outcome.

4.9.2.5 Impact on Financing Arrangements

202. At para. 5.46 of the July Consultation, Ofcom intimates that there would be a limited impact on BT's financing costs since BT would retain ultimate access to Openreach's cash and assets and Openreach Ltd would not raise its own debts. It concedes that there may be "some costs associated" with bondholders and lenders on the change of control of part of the business but does not attempt to analyse or quantify their impact on BT. As described below, this is a gross oversimplification of the impact on BT and its ability to secure finance to fund its ongoing commitments and future investments.

Triggering of liabilities to bondholders

203. BT has a number of outstanding bonds listed on the London Stock Exchange. Three of them contain a disposal event of default which is triggered if BT "ceases to carry on its business or a substantial part thereof". [£]

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204. [~~⊗~~

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205. [~~⊗~~

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i. [~~⊗~~

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ii. [~~⊗~~

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iii. [~~⊗~~

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206. [REDACTED]

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Ongoing cost of debt implications

207. There are wider implications for BT's ongoing cost of debt from a corporate restructuring involving Openreach. When lending to BT, bondholders rely on the future cashflows generated by the entire BT business when determining the risks inherent in such lending. Bondholders require a return commensurate with the perceived risk in any lending. A corporate restructuring which potentially limits, or might at some stage limit, the access of existing and new bondholders to future cashflows of any part of the BT Group, will inevitably increase the perceived risk inherent in such lending and subsequently push up the cost and possibly reduce the volume of debt available to the BT Group. Similarly, [REDACTED]³⁰⁸, the resolution mechanisms between BT and Openreach under the Preferred Model, the specific nature of the arrangements concerning the financial envelope set by BT and the extent of Openreach's discretion in terms of management of its finances will be important factors in determining the rating agencies' and debt investors' reactions and therefore will impact on its cost of borrowing.
208. Similarly, [REDACTED]³⁰⁹ any changes to the pension arrangements or pension deficit resulting from the separation of Openreach may be regarded by credit rating agencies and debt investors as a material downgrade in the credit quality of BT. In BT's opinion, none of the mitigations suggested by Ofcom will alleviate the credit quality issue.
209. Any increase in BT's overall cost of debt arising from changes in the relationship between BT plc and Openreach will feed through to BT's weighted average cost of capital ("**WACC**"). Moreover, the impact on WACC is likely to be greater than that of debt costs alone, as the factors which will increase the aggregate cost of debt (loss of scale/diversification) are also likely to increase the aggregate cost of equity for the same reasons.

³⁰⁸ [REDACTED].

³⁰⁹ [REDACTED].

210. Furthermore, turning Openreach into a “virtually separate” business, that is so independent that it can only take into account its own profits in making investment decisions, will reduce investments for the UK. BT has made bold investment commitments for the country which will be implemented by 2020: fast broadband (at least 10Mb/s) to 100% of premises, superfast (up to 80Mb/s) to 97%-98% and ultrafast (up to 500Mb/s) to 10 million premises and 2 million FTTP premises. We are in progress in delivering a step change increase in customer experience which will be jeopardised by Ofcom’s Proposals. For example, as regards BT’s £2.5bn investment in fibre broadband, 95% of the capital investment was at the Openreach level, but only 60% of the profits. The other 40% of profits were generated by BT’s downstream operations and from the operations of Openreach’s customers supplied on an equal access basis. The ability of BT to make investment decisions on a unified basis is critical to its ability to compete on a level playing field with Virgin Media, who can take account of unregulated end-to-end margins. If BT Group cannot allocate capital on the basis of end-to-end margins, and if it has to find billions of pounds to fund its pension scheme, Openreach will not have the ability to raise funds for broadband investments needed for the future of the country. That will frustrate the policy objectives in the ERF and Ofcom’s regulatory duties.

Public Financing Arrangements

211. All the BDUK contracts for the subsidised roll-out of superfast broadband are also with BT plc and not with Openreach. The network assets deployed as part of those agreements are owned by BT plc, although they form part of the access network for which Openreach is responsible. These contracts are signed with local government authorities for the authorised use of state aid to deploy fibre broadband in intervention areas. BT plc is prohibited from transferring the agreements (including to a subsidiary within BT Group) without the consent of the relevant local authority. There are approximately 80 separate agreements across the first two phases of BDUK with an additional 35 or so projects in the pipeline, where BT will be required to bid on similar terms. Although, some of the BDUK contracts provide that a Local Authority should not “unreasonably withhold” its consent to a transfer, in others their discretion is not qualified in this way. However it is likely that Local Authorities will stipulate conditions for the giving of consent (such as the provision of a guarantee).

4.10 Costs associated with operating Openreach as a separate subsidiary

212. BT would also incur one-off costs and ongoing incremental costs from setting up and running Openreach as a separate independent subsidiary (without demerger), which have not been quantified by Ofcom. These include:
- i. BT estimate (diligence by KPMG) one off costs of approximately [X] in creating and running an wholly owned subsidiary comprising the assets

that Ofcom considers should transfer to Openreach Ltd, along with annual costs of [£];³¹⁰ and

- ii. Costs associated with establishing a boundary between Openreach as a separated upstream entity, separate from BT Group and its downstream operations. Such costs may be static if the boundary is set in the wrong place or dynamic if the boundary needs to change over time to reflect prevailing levels of network competition.³¹¹

213. For the above reasons, BT considers the cost and adverse consequences arising from the implementation of Ofcom's Proposals to be disproportionate and ultimately detrimental to the growth of, and investment, in the UK's communications infrastructure.

4.11 Costs missing from Ofcom's analysis

214. There are other one-off cost and other financial implications for BT from the Ofcom Proposals that have not been fully considered or quantified by Ofcom. These include:

4.11.1 Delay and disruption to projects

215. BT's strategic and transformation projects (such as transformation and cost reduction programmes) "*would be impacted by the management and business requirement to focus on the separation of OR*". BT estimates "*that this will result in the loss in forecast benefits of c. [£] over two years (i.e. [£] per year)*"³¹².

4.11.2 Re-branding costs

216. The one-off costs are "*estimated to be [£], in order to design and implement a full-scale re-brand of OR. Of this, c. [£] relates to agency brand creation and launch. The other [£] includes one-off costs to roll-out the re-brand across the estate (including property, uniforms, stationary etc.). Estimated ongoing costs of c. [£] relate to an incremental 14 FTEs to maintain and develop the brand and external media and production*"³¹³.

4.12 Conclusion

217. In formulating its Proposals, Ofcom has failed to satisfy the legal and procedural requirements required by Article 13a AD, Article 8 of the Framework Directive and the principles of better regulation. Ofcom has applied an ultra vires remedy that is equivalent to structural separation in all but name and legal form. It has failed to identify to identify an appropriate counterfactual for benchmarking its Proposals and starts from the wrong premise, assuming that some form of

³¹⁰ Para. 5.34, Compass Lexecon Main Report and slides 5, 10, 11 and 12, KPMG Impact Report.

³¹¹ Paras. 5.31–5.32, Compass Lexecon Main Report.

³¹² Slide 16, KPMG Impact Report.

³¹³ Slide 16, KPMG Impact Report.

enhanced vertical separation is required and will confer improvements over and above the existing SMP regime and the Undertakings. However, it does not attempt to measure the supposed benefits of its Proposals and fails to link that remedy causally to its concerns of strategic discrimination. In so doing. It has comprehensively failed to show that its proposed remedy is a suitable, efficient or necessary intervention to remedy its concerns.

218. Further, Ofcom has failed to carry out a proper impact assessment or proportionality exercise, which are required as a matter of domestic and EU law, before it can justify recourse to such an extreme form of functional separation. Its outline summary of possible costs that may result from its Proposals is inadequate and grossly underestimates the types and scale of financial, practical and economic costs that would be imposed on BT and Openreach.
219. The July Consultation sketches some of the possible costs that might arise with Ofcom's Preferred Model and suggests potential mitigations that might help minimise those costs. There is also clearly a desire on Ofcom's part to ensure that the costs of the new model do not approach the level likely to be associated with full structural separation. Nonetheless, even after mitigation, the costs of separation will be considerable. Issues of cost recovery inevitably arise. Insofar as these costs are borne by Openreach, they may feed into regulated charges, either because of their direct impact on operating costs or overheads. That will entail higher access charges for CPs which will be passed on to consumers in the form of higher prices.
220. Where extensive costs and other complications are borne by BT rather than Openreach, that is likely to affect its share price and attractiveness to equity investors. The transfer of assets and change of control may also have wider repercussions for its financial arrangements and its ability to obtain finance. A large hit on the bottom line will also affect the financial envelope that Openreach will have for investment projects, including any co-investment initiatives. That uncertainty is likely to jeopardise ongoing investment in critical broadband infrastructure ahead of the superfast broadband commitments for 2020 and beyond.
221. Ofcom does not appear to have carried out any analysis of the impact of its Proposals on consumers' interests. The outcomes outlined in this response would not be consistent with Ofcom's regulatory duties to further citizens' and consumers' interests and ensure that users derive maximum benefit in terms of price, quality and choice of service. Ofcom simply assumes that its Proposals will deliver its desired market outcomes (without explaining how) and has no regard whatsoever to the potential long term detrimental repercussions that its Proposals will have for investments, innovation, and competition in the sector as a whole. That is not consistent with the specific obligations on Ofcom under s.13a2(c) of the Access Directive nor its wider regulatory duties under the Framework Directive and the CA03.

SECTION 5 - BT'S MODEL FOR OPENREACH GOVERNANCE

5.1 Introduction

1. Between November 2015 and July 2016, BT notified Ofcom that it was willing to vary the Undertakings and implement a radical reorganisation of its business to bring into effect enhanced functional separation of Openreach. This has culminated in BT providing a full draft of its notification on 11 July 2016 and formally notifying Ofcom on 18 July 2016, pursuant to Art 13b AD, its intention to implement the BT Proposal - its new governance model, with enhanced functional separation and, on the same date, applying for Variation of the Undertakings pursuant to s.154 EA02. While it does not accept the validity of Ofcom's stated concerns, nor its power to impose a mandatory remedy in the form of Ofcom's Proposals, BT has made this offer voluntarily in the hope that it will avoid the need for a protracted and contentious process, thereby enabling it to continue to focus on investment and innovation for the benefit of consumers and the industry generally.
2. BT believes this new voluntary model, elements of which have been welcomed by Ofcom, provides a comprehensive, effective and proportionate response to the issues raised in Ofcom's review in relation to Openreach governance and independence. The governance model that BT is implementing will help to accelerate Britain's digital future by giving Openreach more control of its strategy, investments and plans, all with the benefit of greater transparency, particularly with regard to decision-making on major new investments in the network. By these means, BT meets all of Ofcom's concerns and all bar the most extreme proposals, so that Openreach can deliver better service, even wider coverage and faster speeds to customers through investment in new services. Such developments will help maintain the UK's leading position amongst the world's digital economies.³¹⁴
3. A key factor of the BT Proposal which supports these outcomes is that it does not give rise to the economic costs or the disproportionate costs of change associated with Ofcom's Proposals. BT's Proposal allows BT to continue to build investment cases and take on risk on an integrated basis subject to Openreach treating all its customers equally. As outlined in the sections above, this underpins the large-scale investment which has occurred to date and which is planned for the future.³¹⁵ In addition, the BT Proposal avoids very costly and disruptive changes caused by Ofcom's Proposals, by changing BT's

³¹⁴ Para. 5.56, Compass Lexecon Main Report: "*it is clear that in the absence of substantiated benefits BT's Proposal should be preferred to Ofcom's on the basis that it is likely to give rise to substantially lower costs.*"

³¹⁵ Para. 5.54, Compass Lexecon Main Report: "*We do not consider that BT's Proposal would give rise to the economic costs associated with quasi-structural separation identified above, because it would allow BT to continue to plan and take on risk on an integrated basis.*"

organisational structure which, on numerous metrics, has been shown to serve the UK market so well to date.

4. BT's Proposal maintains BT's right to retain ownership and enjoy any profits from its investment, but in a delegation framework that provides a reasonable balance between the duties of the BT Group Board of Directors to the BT shareholders and the objective of securing a high degree of independence for Openreach within the broad terms of the financial envelope set by BT as part of its supervisory prerogative.

5.1.1 Legal framework

5. Under the ERF and the CA03, Ofcom must ensure that its regulatory measures are targeted where necessary and proportionate. The burden of proof is on Ofcom to provide reasons justifying the conclusion that greater functional separation involving full independence and incorporation of Openreach is "**the most efficient** means to enforce remedies aimed at addressing the problems or market failures identified"³¹⁶. As part of that exercise, it must ensure that, where there is a choice between several appropriate measures, recourse is made to the least onerous and that the disadvantages are not disproportionate to the aims pursued.³¹⁷
6. Recitals 25 and 27 to the FD make clear that ex ante obligations may only be imposed where national competition law remedies are not sufficient to address the problem.
7. Unlike Ofcom's Proposals, BT's Proposals proposed new governance model is well-developed, with specific details of how it will operate. This demonstrates that it is apt to address the concerns raised by Ofcom and that it is a proportionate response to those concerns. Ofcom's obligation, if it were to wish to pursue its Proposals, would be to prove, with evidence and reasoned analysis as part of a proper cost-benefit assessment, that its Proposals address its concerns (assuming these could be substantiated) over and above the benefits of BT's Proposal. It then has to compare any incremental benefit from its Proposals (assuming any could be substantiated) to the substantial incremental costs entailed by Ofcom's Proposals. BT believes that Ofcom will not be able to make such a case given (i) the benefits offered by BT's Proposal and corresponding lack of any incremental benefit of Ofcom's Proposals, and (ii) the very substantial additional costs and economic disadvantages involved in imposing a remedy which is tantamount in effect to virtually structural separation.
8. This section is structured as follows:
 - a. Introduction;

³¹⁶ Art 13a(2)(d) AD.

³¹⁷ BEREC Guidance, footnote 6 page 8 referring to the *Fedesa* criteria outlined in Section 2 above.

- b. Overview of BT's new model for Openreach governance;
- c. Comparison of BT's Proposal with Ofcom's Proposals;
- d. Ofcom's Proposals do not deliver more than BT's Proposal;
- e. There are no sustainable objections to BT's Proposal;
- f. Conclusion.

5.2 Overview of BT's new model for Openreach governance

- 9. BT's Proposal has a number of interlocking elements. In particular:
 - a. An Openreach Board will be established as a committee of the BT plc board, with delegated authority for the strategy and operational performance of Openreach, in accordance with a Governance Protocol (see below), and with significantly more independent oversight compared to present arrangements;
 - b. The majority of the seven members of the Openreach Board will be independent. This will include the independent Openreach Chairman and three independent non-executive directors who will each meet the independence criteria set out in the Governance Protocol;
 - c. BT plc's articles of association will be amended to provide for the delegation of powers to the Openreach Board (as provided in the Governance Protocol) and to set out the obligation of Openreach to treat all its customers equally;
 - d. The Governance Protocol will clearly define the independence of Openreach within a defined framework. The supervisory controls retained by BT Group plc, and BT plc, and their ability to intervene to resolve material divergences from plan, are limited to matters set out in their governance policies and which are those needed to ensure ongoing compliance with their corporate and listing responsibilities;
 - e. Openreach will have a significantly enhanced discretion to devise its strategy and to manage and control its day-to-day activities and operational decisions within the scope of that framework; and
 - f. An enhanced formal process will be introduced concerning how Openreach consults with all CPs on large scale investments, including a confidential phase where Openreach will not disclose information outside of Openreach, except to the BT Group CEO and BT Group CFO in defined circumstances as set out in the Governance Protocol. Under this confidential process, Openreach will be able to consider proposals to fund major network investments under co-investment or risk-sharing agreements with CPs.

10. BT intends to implement as many of the key elements of our new Openreach governance model as it can by 18 January 2017³¹⁸ whilst remaining compliant with the Undertakings in their current form.
11. BT notified the model to Ofcom under s. 89C of the CA03 and Article 13b of the Access Directive relating to voluntary separation by vertically integrated CPs. The notification is available online on BT's website at <http://www.btplc.com/ukdigitalfuture/index.htm>, together with detailed supporting documentation.³¹⁹
12. At the same time, BT submitted an application to vary the Undertakings under s.154 EA02, part of the UK's domestic competition law regime. Some of the changes BT has proposed are necessary consequences of its new governance proposal, while others are to bring the Undertakings up to date and, for example, to remove now obsolete time bound commitments. There are clear benefits to the approach that BT is proposing. In particular, incorporation of the new Governance Charter as an annex to the Undertakings will confer legal enforceability by both Ofcom and other interested stakeholders.

³¹⁸ There are some aspects of our model that can only be implemented if Ofcom agrees to the Undertakings variation request that we have submitted, however, this does not apply to the key governance changes such as the establishment of the Openreach Board, the amendment of the Articles of Association of BT plc, and the new formal three-phase CP consultation process.

³¹⁹ The documentation consists of:

- A core submission document, setting out the details of our model, our reasons for developing and implementing it, why it is an effective and proportionate response to the concerns raised in the DCR, and explaining the statutory basis for the model;
- The Term Sheet, which summarises the model (but has no legal force);
- BT plc's notification to Ofcom of its intention to effect enhanced functional separation of Openreach in accordance with s. 89C CA03;
- An application to vary BT's Undertakings;
- In support of the application to vary the Undertakings, a revised set of the Undertakings, plus a mark-up in a form that shows all proposed changes to the Undertakings in force on 15 July 2016, and a draft legal instrument to give effect to the revised Undertakings;
- BT Group's proposed Openreach Governance Protocol, forming an Annex to the revised Undertakings, which comprises:
 - Part A: terms of reference for the Openreach Board;
 - Part B: duties of the Openreach executive management team (the "Openreach Executive");
 - Part C: matters reserved for the BT Group board and the BT plc board;
 - Part D: details of an enhanced Openreach customer consultation procedure;
 - Part E: proposed changes to the Articles of Association of BT plc.

5.3 Comparison of BT's Proposal with Ofcom's Proposals

13. The BT Proposal is suitable and effective because:
 - a. it addresses Ofcom's specific concerns about Openreach's independence and governance;
 - b. it confers additional benefits on BT and/or Openreach and/or the sector as a whole, over and above Ofcom's Proposals; and
 - c. it implements the new governance model in a practical and measured basis which avoids the financial and economic cost implications associated with Ofcom's Proposals.
14. BT deals with those matters below before turning to a more detailed comparison of the impact of the two models on its business operations, to ascertain whether the positive benefits of each model outweigh any negative effects. Lastly, BT rebuts Ofcom's criticisms of its Proposal.
15. In comparison, Ofcom's Proposals are disproportionate and ultra vires. Ofcom's approach is flawed because it has not undertaken the required analysis of alternative means of addressing its alleged competition concerns, and specifically their relative costs and benefits, to show that Ofcom's Proposals are the "the most efficient means to enforce remedies aimed at addressing the competition problems or market failures."³²⁰ Ofcom has not undertaken any such analysis.
16. In the context of its inadequate assessment of the pension costs associated with its Proposals, Ofcom states: "*In the event that any increased risks resulting from our proposals could not be sufficiently mitigated, we are open to considering alternative approaches that would avoid incurring significant costs disproportionate to the benefits from any intervention.*"³²¹ Whilst the principle of assessing whether costs are disproportionate relative to the benefits of intervention is valid, Ofcom is wrong to reverse the burden of proof in identifying and assessing alternative approaches, nor should this assessment be applied only in relation to pensions but to the costs and benefits of the intervention in general.

5.3.1 BT's Proposal addresses the concerns raised by Ofcom

17. BT's Proposal represents a substantial, voluntary reorganisation of BT's business which we believe is unprecedented in the telecommunications industry. It will take BT beyond its current level of functional separation, which already goes well beyond models that have been implemented in any other European countries. It is a comprehensive, coherent solution that is designed to deliver materially enhanced independence for Openreach and transparency for CPs, whilst preserving the benefits for end-consumers and the rest of the

³²⁰ Art 13a(2)(d) AD.

³²¹ Para. 5.7, July Consultation.

UK from BT Group's vertical integration, appropriately balanced by a general obligation on Openreach to treat all its customers equally, and protecting BT Group's proprietary rights as the owner of Openreach.

18. In doing so, it delivers an effective and proportionate response to the issues raised by Ofcom and other stakeholders, even though these concerns are unfounded, in relation to governance of Openreach, ongoing service issues and the process for consultation of CPs. BT's Proposal, in combination with the existing SMP regime, will address those concerns while preserving the clear benefits of vertical integration and BT Group's rights of ownership.
19. The key features in this regard are as follows:
 - a. Strengthened formal obligations on Openreach to treat all its customers equally, incorporated into the Articles of Association of BT plc. This provision matches that in Ofcom's proposals. This supplements the legal obligations set out in the current Undertakings and regulatory conditions set by Ofcom in most of the markets where it has found BT to have SMP. This enhanced non-discrimination obligation and the enhanced independence of Openreach are more than sufficient to dispel Ofcom's concerns regarding Openreach's alleged incentives to discriminate against other CPs (which do not in fact exist, and could not be acted upon by Openreach under the present functional separation arrangement as set out in more detail in Section 6 below);
 - b. More independent governance, through the independent Openreach Board, which will be accountable for Openreach's strategy and operational delivery and governed by the obligation to treat all customers equally. This provision matches Ofcom's Proposals. The Board will have a majority of independent directors, including the Chair and three non-executive directors. This provision matches Ofcom's Proposals;
 - c. The Openreach CEO will be accountable to this Board and will report into the BT Group CEO; This is an appropriate balance between the proprietary rights of BT as the owner of Openreach and the independence of the Openreach board, overcoming the draconian costs of BT having to de-consolidate Openreach and avoiding virtual structural separation;
 - d. Increased autonomy for Openreach over its strategy, budget and decision-making. Openreach will produce Annual Operating and Medium Term Plans setting out its budgetary, strategic and operational objectives. These provisions match Ofcom's Proposals, subject to BT's continuing rights sufficient to avoid the de-consolidation of Openreach. The Openreach Board and CEO will also control how they deploy capital within the overall budget, in line with Ofcom's Proposals;
 - e. Improved Openreach approach to consultation with its customers through the new formal consultation process with three phases for

substantial investment decisions outlined above which includes a confidential phase – matching Ofcom’s Proposals; and

- f. Enhanced operational capability, with resources within Openreach that are sufficient to enable it to make its own decisions and run its own operations – fulfilling Ofcom’s requirements. This includes the transfer of certain TSO functions such as research and systems, and certain employees into Openreach.
20. As BT sets out in Section 3, Ofcom has not substantiated its concerns relating to strategic discrimination. However, the BT Proposal delivers everything that Ofcom and CPs are seeking, in particular a further reinforcement of Openreach’s focus on its customers and the development of products that serve the interest of all CPs equally, barring the extreme and disproportionate elements of Ofcom’s Preferred Model. The proposed enhancement to CP consultation allows Openreach to consider proposals to fund major network investments under co-investment or risk-sharing agreements with CPs, on a confidential basis.
 21. BT’s Proposal should also be seen against the backdrop of the commitments that Openreach has made to deliver a step change in customer service, broader coverage of fast and superfast broadband and ultrafast broadband to 12 million homes and businesses by the end of 2020 using both FTTP and G.fast technologies.³²²
 22. BT’s Proposal also includes a commitment that Openreach will be open to receive investment proposals from CPs on a co-investment or risk-sharing basis. Such proposals would be governed by the new three-phase consultation process BT intends to implement, which includes a phase in which confidential information is kept within Openreach, until such time as BT capital required from BT to finance co-investment schemes.
 23. The implementation costs of the BT Proposal would be drastically lower than those of Ofcom’s Preferred Model which would result in disproportionate financial burden and economic costs. The implementation of the BT Proposal would result in approximately [£<] incremental costs and [£<] per annum on-going costs. In contrast, Ofcom’s Preferred Model on the basis that it triggers deconsolidation (which is likely) would result in close to [£<] in one-off costs and approximately [£<] per annum on-going costs.³²³ The BT Proposal therefore addressed Ofcom’s concerns in an effective manner and constitutes a much more proportionate solution to the issues raised in Ofcom’s review. As the incremental benefits from Ofcom’s Preferred Model over BT’s amount to zero, Ofcom’s Preferred Model must by definition fail a proper cost benefit analysis and the proportionality test. It cannot be “the most efficient means”

³²² <http://www.btplc.com/News/#!/pressreleases/bt-to-invest-billions-more-on-fibre-4g-and-customer-service-1394948>

³²³ See slide 12, KPMG Impact Report.

when a less intrusive solution (i.e. BT's Proposal) achieves better outcomes at considerably lower cost and disruption.

5.3.2 Other benefits from BT's Proposal for BT and Openreach

5.3.2.1 Corporate Governance

24. BT's Proposal preserves an appropriate level of visibility and control for BT over Openreach's activities in line with accounting standards and corporate governance best practice. As a listed company, BT Group plc applies the UK Corporate Governance Code ("UK Code") published by the Financial Reporting Council. The UK Code aims to "facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company."³²⁴
25. In 1992, the Cadbury Committee which produced the first version of the UK Code, defined corporate governance as "the system by which companies are directed and controlled." The Committee also stated that:
- "Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship."*
26. Accountability is a key principle of good corporate governance. The Board of BT Group plc is ultimately accountable to the company's shareholders and therefore owes them a number of duties to safeguard their interests. As such, the Board of BT Group plc must be able to exercise control over BT's business and the Board must be able to carry out its supervisory responsibilities to ensure that the shareholders' (and other stakeholders') interests are protected. Accordingly, there must be an appropriate level of both visibility and control over the activities of BT's business by the BT Group plc Board. BT's governance model achieves the necessary visibility and control, unlike Ofcom's Proposals which would not be compatible with corporate governance principles.

5.3.2.2 Preserved benefits of vertical integration

27. BT's Proposal preserves the benefits of vertical integration, while appropriately balancing these with Ofcom's requirement that Openreach treats all its customers equally in its strategic and investment decision-making, and avoids the risk of their being undermined by creating a wholly independent, legally separate company in which Openreach investment decisions have to be made in isolation of any end-to-end considerations.
28. This means that BT's retail divisions can still act as anchor tenants to support continued investment in the access network, in circumstances where the

³²⁴ UK Code, para. 1.

interests of all CPs are protected by equal treatment requirements and downstream margin protection under competition law and regulation. Openreach has access to an anchor tenant (namely BT's downstream operations) to whom it can market new services and technological innovations. If services are profitable for BT's downstream operations they must also be profitable for other CPs. Openreach will have the security of their commitment to market such services to their customers ensuring that new network assets are utilised quickly and that the same services are available to all CPs at the same time in exactly the same way.

29. Major network investments require coordinated commitment and an overview of end-to-end margins in order to make the business case pay back to justify the investment in the first place. Coordinated decision-making also encourages efficient investments and innovation as new services can be appropriately "market tested" as BT's retail margins will reflect the value placed on investments by BT's end user and act as proxy for likely take up by other CPs. Without the benefits of vertical integration, investment decisions made by Openreach in isolation will be lower (because retail margins cannot be considered), will be less well aligned with end-customer interests (for the same reason) and will be more cautious (because of the uncertainty of demand) which would result in an adverse impact on investment to the detriment of all CPs and the whole country.
30. Other pro-efficiency coordination benefits result from appropriate vertical integration, including facilitating cost-effective interactions between the upstream and downstream business units in ways not possible to replicate by contract. For example, as part of a single entity, Openreach and the rest of BT do not need to formalise supply and demand commitments or risk allocation contractually. This is particularly relevant in the context of strategic investments, the benefits of which will not be known for many years.³²⁵
31. BT's Proposal is in stark contrast with Ofcom's Proposals, which require that Openreach will make investment decisions without reference to the wider commercial interests of the rest of the BT Group.
32. Similarly, BT's Proposal means that the BT Group has an incentive to make use of Openreach networks and promote take-up of services provided over them. Ofcom's Proposals risk undermining such alignment of incentives, if as a result of independence and the lack of coordinated or integrated planning, Openreach invests in services that downstream entities do not value or are not value creating for shareholders.

5.3.2.3 Flexible approach to the Openreach boundary

33. BT's Proposal will retain the flexible approach to the Openreach boundary that has existed under the status quo: as there is no firm and final split of different network assets, the boundary may change from time to time to reflect market developments or shifts in Ofcom's competition strategy. This is extremely

³²⁵ Para 5.45, Compass Lexecon Main Report.

important given that technology is changing rapidly and that markets are similarly changing rapidly – Ofcom has already found that some access markets are already competitively supplied. In the recent BCMR, Ofcom found that all access markets in the Central London Area are competitively supplied, and that the London Periphery is, essentially, prospectively competitive. There must be a high likelihood of expansion of the competitive footprint in the next market review. Similarly, Ofcom recognises that there are areas where new entrants will enter Fixed Access markets alongside BT and Virgin Media. Indeed, Ofcom has stated that effective network competition with three competing networks serving around 40% of customers could well develop (“be a good outcome”). It therefore follows that the regulated footprint, and hence the areas where Ofcom will be entitled to mandate functional separation, can be expected to change and to decline in the coming years and that the boundaries of Openreach may need to adapt accordingly.

34. By contrast, incorporation of a separate subsidiary makes matters more complex, rigid and costly than they are under the status quo, as ownership of assets would have to be transferred between legal entities separated by a corporate veil, subject to agreement of independent boards, whose interests are unlikely to be aligned. In the current functional separation model, assets can be reallocated without triggering a change of ownership.
35. BT’s Proposal provides greater flexibility for changes to the Openreach boundary, subject to agreement of Ofcom, since transfer of assets between Openreach and other parts of BT would be governed by the Undertakings, without triggering a change to the legal ownership of the assets.

5.3.3 BT’s Proposal avoids disproportionate costs and complexity for BT and Openreach

36. There are clear advantages to Openreach remaining as an appropriately vertically integrated part of the wider BT Group without the need for legal separation or transfers of assets and/or staff. BT’s Proposal avoids the disproportionate financial burden and economic costs and other disadvantages that arise from Ofcom’s Proposals, including:
 - a. integrated decision making is preserved promoting both investment and innovation and protecting equal treatment;
 - b. there should be no material impact on the BT pension deficit or the BT employer covenant;
 - c. whilst BT’s Proposal also contemplates BT bearing all the downside risks, BT’s ability to identify and manage those risks (within existing regulatory restraints) is preserved
 - d. the complexities relating to the Crown Guarantee and its applicability to Openreach employees will not arise as they will remain employed by BT;

investing a further six billion pounds in its fixed and mobile networks over the next three years.

5.3.5 Procedural and Enforcement advantages of BT's Proposal from the NRA Perspective

41. In addition to the substantive advantages set out above, BT notes that its Proposal has a number of significant procedural advantages, deriving from the fact that it is a voluntary amendment to the status quo (based on ss. 154 and 155 EA02 and Article 13b AD/s. 89C CA03) rather than mandatory alteration to Openreach's governance arrangements (subject to the highly restrictive provisions of Article 13 AD and ss. 89A and 89B of CA03). These advantages can be summarised as follows.
42. First, BT's Proposal does not require Ofcom to demonstrate that the detailed statutory conditions set out in Article 13a AD and s. 89A of CA03 are met. As BT has already explained in Section 4 above, Ofcom has not come close to meeting that requirement. The jurisdictional requirement of ss. 154 and 155 EA02, that Ofcom considers there to be a structural feature of the UK market that would justify a reference to the CMA (see s. 131 EA02), is substantially less demanding than the conditions laid down in Article 13a and s. 89A, although it should be noted that there are limitations on any remedy that the CMA could impose, given the terms of restrictions required by the ERF before specific ex ante regulatory obligations being imposed on telecommunications operators (see Section 2, para. 45 above).
43. Secondly, BT's Proposal is general in scope, whereas Ofcom's Proposals would impose an exceptional SMP condition which, by definition, can bind BT only on product and geographic markets where BT enjoys SMP, which would in turn involve Ofcom in a complex process of review and revision of the condition over time to ensure that it is not imposing an unlawful obligation on BT.
44. Thirdly, BT's Proposal provides Ofcom with a prompt and efficient means to achieve its strategic objectives, without the need to engage in lengthy and time-consuming legal procedures with uncertain outcomes. It does not require any third party notification or approval procedure to be followed. It would not require Ofcom to prepare a detailed reasoned application, justifying the imposition of an exceptional SMP condition falling within the scope of Article 8(3) or Article 13a (ss. 89-89B CA03). Nor will it have to deal with the regulatory uncertainty of obtaining the approval of the EU Commission or consulting BEREC.
45. Fourthly, the form of BT's Proposal is not subject to the substantive limitations of Article 13a AD and s. 89B of CA03, given that BT is offering its proposals as a form of voluntary restructuring of the governance arrangements of Openreach. In terms of efficient use of resources, the role of Ofcom under Article 13b AD and s.89C of CA03 is limited to scrutinising the proposal from the perspective of existing SMP regulation (as well as discharging its statutory duties under UK domestic law as specified in ss. 154(7) and 162(2)(c) of EA02:

as to which see Section 2, para. 74, above). However, those demands will be much less exacting and time-consuming than the Article 13a procedure.

46. Fifthly, applying the guidance set out in §2.1 of OFT 511, it is extremely doubtful that a reference to the CMA would be an appropriate alternative to undertakings in lieu, both because of the delays and costs involved in a market investigation by the CMA and because of the limitations on any remedy that the CMA could impose as noted above. BT's Proposal for amended undertakings in lieu of such a reference would therefore clearly fall within the terms of the relevant administrative guidance.
47. Sixth and finally, BT's Proposal would maintain the status quo in terms of enforcement, with Ofcom having full enforcement powers in respect of existing SMP regulation under the ERF and CA03 in combination with the enforcement and monitoring provisions of EA02 in respect of the amended undertakings.

5.4 Ofcom's Preferred Model does not deliver more than BT's Proposal

48. The core difference between Ofcom's Preferred Model and BT's Proposal is the extreme degree of independence achieved by placing Openreach behind a "corporate veil", which entails the physical and legal separation of Openreach and its separation of Openreach into an incorporated subsidiary with the transfer (under Ofcom's Preferred Model) of people, assets and trading. Incorporation in itself does not add any benefits additional to those that BT's model will deliver. As confirmed in external advice provided to BT by Freshfields Bruckhaus Deringer, which has been previously shared with Ofcom,³²⁷ from a legal perspective, incorporation in itself does not add any benefits additional to those that BT's model will deliver.
49. In its Initial Conclusions documents published in February 2016, Ofcom set out a number of broad elements which it believed should form part of new governance arrangements based on Openreach as a wholly owned subsidiary. Our analysis below of these broad elements demonstrates the lack of any additional benefits from incorporation.

5.4.1 The argument that incorporation makes the relationship between Openreach and BT's other divisions becomes more transparent³²⁸

50. Incorporation per se does not make the relationship between the parent and the subsidiary more transparent. Many companies operate subsidiaries which are entirely opaque to outside market participants, despite respecting statutory provisions. Transparency is brought about only by means of regulation requiring transparency. Incorporation adds nothing.

³²⁷ Letter to BT dated 20 April 2016, previously provided by BT to Ofcom.

³²⁸ See para. 4.13, July Consultation.

51. In BT's Proposal, the relationship between BT and Openreach is made more transparent because it is specified in the Undertakings, Articles of Association and the Governance Protocol which have been published on BT's website. The Openreach Board, with its majority of independent members, would monitor Openreach's and BT's compliance. Incorporation adds nothing to the transparency yielded by BT's Proposal. Moreover, by being incorporated into the Undertakings, the checks and balances in the new governance model are enforceable by Ofcom which provides legal certainty.

5.4.2 **The argument that the Openreach Board would take decisions in the interests of Openreach rather than the wider interests of BT Group**³²⁹

52. Incorporation does not necessarily entail the Openreach Board taking account of the interests of Openreach in isolation. It is of course perfectly common for the board of a 100% wholly-owned subsidiary to take into account the interests of their shareholder, who is assuming the entirety of the risk arising from investments. Under English law, a board has a statutory obligation to promote the success of a company for the benefit of its shareholders. It would only be by virtue of an amendment to the company's purposes under its articles of association or potentially express regulation, not incorporation, that a subsidiary board would be constrained not to take into account the end-to-end interests of a 100% shareholder, or to take into account other interests over and above a shareholders' interests, such as a requirement to treat all customers equally.³³⁰
53. BT's Proposal achieves an independent Openreach Board, with a majority of independent directors, without incorporation. Further the duty to take account of customers' interest equally is built into the Governance Protocol and the Articles of Association of BT plc and binding on the directors of the Openreach Board.

5.4.3 **The argument that Openreach would have the responsibility to treat all customers equally**³³¹

54. The inclusion of an obligation to treat customers equally in the articles of association of Openreach (if it were incorporated) adds no value relative to the imposition of the same obligation by regulation. The directors of a board have the same obligation to comply with regulatory obligations whether these are built into the articles of association or imposed by regulation. Including the obligation in the articles of association alone also gives Ofcom no enforcement powers, unless the obligation is also a regulatory requirement or Undertakings commitment. Only shareholders have rights to enforce the articles. A 100%

³²⁹ See paras. 4.15 and 4.29, July Consultation.

³³⁰ In Section 2, para. 22 above, BT noted that Ofcom had recognised that requiring any greater functional separation than it was then proposing "*would not be compatible with the continuing duties of a single board of directors of British Telecommunications plc.*"

³³¹ See paras. 4.13 and 4.30, July Consultation.

shareholder can change the articles at will by passing a special resolution. The duty to observe regulations and articles of association does not arise from incorporation. The duty on the directors of Openreach, whether they are members of a company board or a committee of a company board, are the same.

55. In any case, BT's Proposal has offered to build this obligation into the Articles of Association (of BT plc) to bind all the decisions of the Openreach Board, to meet Ofcom's objective. It is also incorporated into the Governance Protocol, which will be enforceable by Ofcom since it will form part of the revised BT Undertakings. So whatever benefit might arise from Ofcom's Proposals is not unique and is easily replicated by less restrictive models, such as BT's Proposal.

5.4.4 The argument that Openreach would gain autonomy over capital investments and use of cash³³²

56. Incorporation does not itself result in a subsidiary company having autonomy over its capital investments or the use of its cash as funding is typically controlled by the parent company (which may impose conditions on the use of any funds provided). Such autonomy could arise if the parent company agreed to it, but that would be extremely unusual given that the parent company would be taking 100% of the risk of investments but have no influence over the autonomous conduct or decisions of its subsidiary. Alternatively, such autonomy could be imposed by regulations or Undertakings binding upon BT plc as parent company.
57. In any event BT's Proposal ensures Openreach has an appropriate degree of independence in decision-making regarding strategy, investments and operational decisions, without the need for legal incorporation of a separate company. Openreach can take such decisions within the financial envelope agreed with BT in the AOP and MTP under the terms of the Governance Protocol. So any benefits that might arise from autonomy have nothing to do with legal incorporation per se and can be achieved via less restrictive means.

5.4.5 BT Group could finance Openreach without directly influencing how the funds are spent, or Openreach could raise funds from the markets or through downstream providers "secured by contract"³³³

58. An incorporated, 100% owned subsidiary company does not typically have autonomy to use its cash or to raise capital without the oversight or approval of the parent company. It is not consistent with the corporate governance duties owed by the parent company to its ultimate shareholders, who would be taking 100% of the risks of investment without any control on what finances were being raised or how such funds were being spent.

³³² See paras. 4.40-4.53, July Consultation.

³³³ Also see para. 4.40, July Consultation.

59. In any event, BT's Proposal provides Openreach with a considerable degree of independence in determining its strategy, investment and operational decisions within the financial envelope agreed with BT in the AOP and MTP under the terms of the Governance Protocol. Constraints on the extent of BT's influence over Openreach's decision-making can therefore be provided through alternative mechanisms without the need for legal incorporation of a separate company.

5.4.6 The argument that BT Group shareholders retain full ownership of Openreach and continue to benefit from profits

60. Incorporation of Openreach does not give rise to the benefit that BT would retain full ownership and benefit from profits since BT already has full ownership and benefits from profits under the status quo. In Ofcom's Proposals, BT Group shareholders would bear all the risk while having no control and inadequate corporate governance safeguards. This arrangement is not consistent with the fundamental right to run a business³³⁴ or the responsibilities of corporate governance.
61. BT's Proposal maintains BT's right to retain ownership and enjoy any profits from its investment, but in a delegation framework that provides a reasonable balance between the duties of the Board of Directors to shareholders and the objective of securing a high degree of independence for Openreach within the broad terms of the financial envelope set by BT as part of its supervisory prerogative. This balance does not arise from incorporation.

5.4.7 The argument that statutory accounts (balance sheet, P&L and cashflow statement) improve transparency of cost and assets allocation

62. Incorporation does not provide greater transparency of cost and asset allocation. Ofcom already controls the cost and asset allocation between Openreach and the rest of the BT Group through ordinary SMP obligations relating to regulatory accounting so there is no need for incorporation or the exceptional recourse to Art 13a AD to achieve this. The regulatory accounts already define Openreach's assets and costs in enormous detail, such that statutory accounts add no additional transparency or information. BT is already obliged to provide a reconciliation between Openreach's (CCA) regulatory accounts and (HCA) statutory accounts.
63. One does not need to incorporate a separate legal subsidiary to produce a set of accounts to statutory standards. Pursuant to BT's Proposal, it would be equally possible to produce accounts for Openreach equivalent to a statutory standard, which would have to be consistent with the SMP regulatory accounting obligations that Ofcom has imposed on BT.

³³⁴ Article 1 Protocol 1 ECHR.

5.5 There are no sustainable objections to BT's Proposal

64. In its July Consultation, Ofcom welcomes many aspects of BT's Proposal and concedes that it goes a long way in addressing its concerns:

"7.30 We consider BT's plans demonstrate several areas of common ground between Ofcom and BT on how specific measures could support greater strategic and operational independence for Openreach. In particular, the confidential process for consultation on new investment proposals, the composition of the Openreach committee (with a majority of independent members) and enhanced resources for stronger strategic and technical capabilities within Openreach would help address concerns regarding Openreach's focus on investing and developing new products that serve the best interests of all Communications Providers. BT's intention that there be an obligation on Openreach to treat all customers equally would also help to ensure that the focus of Openreach is on its customers."

65. However, Ofcom identifies three broad features of BT's plans that raise concern:
- a. *the status of Openreach as a division of BT plc, rather than as a separate legal entity³³⁵;*
 - b. *the high degree of involvement of the BT Group Executive and Chief Financial Officer in Openreach's management³³⁶; and*
 - c. *access to confidential information during consultations with CPs³³⁷.*
66. These objections are not sustainable, as set out below where each has been dealt with in turn.

5.5.1 Status of Openreach

67. Ofcom's Proposals insist on a change to the current structure to create a legally separate entity with its own Board of directors and (in the case of its Preferred Model) its own employees. However, the legal status of Openreach is not determinative of the extent of Openreach's independence. Nor is it necessary to have its own employees in order that these are well defined and separated from the rest of BT's other divisions. As shown above, BT's Proposal envisages an Openreach Board with a majority of independent directors. The Openreach Board will also be subject to the obligations in the Governance Protocol and the Undertakings as well as BT plc's Articles of Association, which include for example the obligation of the Board to promote the success of Openreach.

³³⁵ Para. 3.31.1, July Consultation.

³³⁶ Para 7.31.2, July Consultation.

³³⁷ Para. 7.21.3, July Consultation.

5.5.2 Degree of executive oversight

68. In BT's Proposal, the Openreach CEO will be accountable to the Openreach Board as well as report to the BT Group CEO and, as now, the Openreach CFO will report to the Openreach CEO. BT's Proposal places limits on the circumstances in which decisions on Openreach strategies and plans need to be approved by the BT Group CEO and BT Group CFO. For example, the BT Group CEO and CFO will only approve Openreach investments which fall outside the parameters of the MTP or AOP.
69. BT Group is a listed company and needs to have oversight of such a significant part of its business (approximately 40% of BT Group's EBITDA) in order to ensure that it continues to be able to comply with its ongoing financial reporting and fiduciary obligations imposed on them by company law.
70. In addition, the BT Group board holds the BT Group CEO to account for the performance of BT as a whole, comprising all of its lines of business and subsidiaries. Having this single point of accountability is key in enabling the BT Group Board to discharge its legal and regulatory obligations, including its obligations to its shareholders. It enables both the necessary flows of requisite information to take place on a continuous basis to comply with listing requirements (see para. 91 of Section 4) and the BT Group plc CEO in turn to hold the Openreach CEO accountable for the Openreach element of BT's performance and satisfaction of relevant legal and regulatory requirements.
71. Finally, from a management perspective, the personal accountability of the Openreach executive, exercised, for example, through direct reporting lines to BT Group is likely to result in more effective delivery of services to downstream CPs. In this context, BT's Proposal which introduces specific remuneration incentives for Openreach executives on the basis of criteria directly monitored by BT Group is likely to further improve the service level criteria already imposed on the company through regulation.

5.5.3 Access to confidential information

72. Ofcom is concerned that BT Group's CEO and CFO could have access to confidential information disclosed by BT's downstream competitors to Openreach as part of confidential consultations.
73. In fact, under BT's Proposal, the BT Group CEO and CFO would only have sight of confidential information from CPs during the confidential phase of the consultation process in specific very limited circumstances that are set out in para. 1.3 of Part D of the Governance Protocol, in particular where:
 - the CP has given consent for disclosure;
 - the proposals for investment are considered by Openreach to be of significant strategic importance to BT;
 - the proposals cannot be financed within the agreed capital expenditure budget of Openreach; or

- the investment would be incremental to the MTP and AOP and would be NPV negative for Openreach.
74. The disclosure permitted under these very limited circumstances has been included in our proposal on strictly pragmatic grounds: it would not be sensible for Openreach to commence the public phase of the consultation process if it was unsure that additional required funds were available or if the proposal might be uncertain for other reasons, such as on grounds of significant incompatibility with BT's strategy.

5.6 Conclusion

75. For the reasons set out in this section of the response, it is clear that BT's Proposal is an effective and efficient means of addressing Ofcom's concerns. The BT Proposal confers the same benefits as Ofcom's model but without the costly interference with BT's right to operate its business and without the hugely disproportionate economic costs and disadvantages of Ofcom's Proposals.
76. Further, BT's Proposal delivers significant benefits for the industry, its customers and the wider UK economy; significantly more than Ofcom's Proposal.
77. BT's Proposal will generate efficient investments, stimulate competition and innovation, underpinning an obligation to treat all CPs equally, and deliver a better outcome for consumers in terms of choice, quality and cost of services. In contrast to Ofcom's Proposals, BT's Proposal represents a coherent and practical solution which is consistent with the wider regulatory framework and addresses all the concerns that Ofcom has identified.

SECTION 6 - OFCOM'S PROPOSAL FOR MEASURING SUCCESS

6.1 Introduction

1. In Section 6 of the July Consultation, Ofcom makes clear that it intends to maintain a watching brief on the success of its intervention by reference to a wider set of market outcomes. Ofcom sets out the positive outcomes it expects to see if its Proposals are implemented and the measures of success against which it proposes to judge how effectively its intervention would address its concerns. The precise nature of the concerns is not identified in Section 6, but presumably these are the alleged strategic discrimination and concerns with FTTP roll-out as identified in the July Consultation.
2. BT considers the arrangements proposed by Ofcom to be unsuitable, impracticable and likely to set BT up to fail. Constant review and threat of action imposes regulatory uncertainty that will damage confidence and investment. In some instances the monitoring regime proposed by Ofcom involves metrics which are outside of BT's direct control: BT cannot be held responsible for the actions of others. BT can only be legitimately measured against the steps it itself takes to implement its proposals and any other remedy and ensure compliance with the requirements of any remedy. In addition, any such metrics should relate directly to the specific regulatory proposals under consideration – i.e. directly attributable to the suggested changes in the governance structure of Openreach from enhanced functional separation – rather than to all regulatory measures imposed under normal SMP regulation.
3. Inappropriately holding BT to account for outcomes it does not control, or which relate to other regulation, risks creating a period of uncertainty which will further undermine investment incentives and, ultimately, risks setting BT up for failure.
4. In para. 6.2 of the July Consultation, Ofcom lists the following three categories of positive outcomes it expects to see as a result of its Proposals:
 - a. Openreach behaviours, in particular its responsiveness to customers;
 - b. Industry outcomes, in particular levels of competition, investment and innovation; and
 - c. Consumer and business outcomes, including availability, quality, choice and pricing of services.
5. BT's principal response is that Ofcom has not made out the case for intervention in the form of mandatory additional functional separation pursuant to Article 13a/ss. 89A and B, based on market failure and/or exceptional circumstances. Notwithstanding that position, for the reasons set out in detail in Section 3, BT has notified Ofcom that it intends to implement measures to give Openreach more control of its strategy, investments and plans, all with the benefit of greater transparency, particularly with regard to decision-making on major new investments in the network. BT is also committed to further

investment to improve the quality of service relating to some of its products. BT has already sought to address these issues and has made specific commitments to that effect, details of which are provided at 34 to 38 below.

6. The remainder of this section provides the reasons why, in our view, the measures of success proposed by Ofcom in the July Consultation are not appropriate in determining the effectiveness of the proposed new governance model as a form of regulatory intervention designed to achieve the positive outcomes sought by Ofcom. We have also provided some specific comments on the themes identified in Ofcom's Proposals and the recent changes we believe will enhance and deliver further improvements on the existing regime.

6.2 Proposed measures are not appropriate

7. First, we are concerned that in considering how to 'measure success' in relation to its strategic review proposals, Ofcom appears to be unclear about its regulatory objectives. The measures should be designed in a way that provides clarity to BT and other stakeholders on: what is being measured; for what purpose; who is accountable for delivering required outcomes; and the appropriate frequency of review of the relevant outcomes. It is reasonable to expect that it would be clear in advance what Ofcom would do in the case that any particular metric is not, in Ofcom's view, met – at the very least in the form of guidance around how Ofcom would expect to investigate and enforce the relevant measures, and consequences of BT failing to meet any clearly specified metric.
8. For the reasons set out in Section 3 above, Ofcom has failed to establish the basis for mandatory regulation in the form of virtual structural separation. Nonetheless, given that the July Consultation focuses exclusively on this, it follows that any review and monitoring of the success of Ofcom's Proposals must also focus on outcomes directly attributable to the suggested changes in the governance structure of Openreach.
9. Ofcom should therefore clarify how the proposed changes in Openreach's structure are designed to fit in with the objectives and outcomes expected from all relevant Key Proposals, so that it is clear to all stakeholders how these governance changes, taken as whole, are intended to deliver Ofcom's broader regulatory objectives and how the individual contribution of different elements of Ofcom's reform package may be distinguished for measurement purposes.
10. Second, the positive outcomes suggested by Ofcom are impossible to measure without Ofcom setting specific performance indicators for BT allowing it to measure "success" or track progress on its performance. The most specific **qualitative** examples are included in para. 6.6 of the July Consultation: "evidence from customers on the responsiveness of Openreach" and an assessment on "whether Openreach has the necessary commercial and technical resources required to deliver its priorities and what it has done to deliver these" as the ways in which BT is expected to assess its own performance in this context, which are themselves vague and unclear. This lack of specificity renders compliance impossible. If tests of this kind are to be used,

then it would be necessary to introduce suitable **quantitative** criteria that could be used by BT and Ofcom to assess success or failure on a more objective basis.

11. Third, Ofcom's interventions are not only impossible to measure but will defeat the achievement of some of its objectives. As set out extensively above, the result of the virtual structural separation of Ofcom's Preferred Model will be to damage and reduce investment at the Openreach level, to the detriment of all CPs and to the country. This will not just undermine BT's incentive to invest, but will compromise Openreach's ability to compete. It will also reduce investment by others at the Openreach level, who will be deterred by the severity of Ofcom's interventions from making infrastructure investment.
12. Even setting aside the severity of Ofcom's virtual structural separation, the level of investment at the infrastructure level in fixed communications will to a large extent be determined not by BT's conduct or Openreach's conduct, but by Ofcom's regulations. The impact on infrastructure investment and competition is a key aspect of the appeals by BT and others of Ofcom's Business Connectivity Market Review. BT's appeal argues that Ofcom's approach of mandating dark fibre will inevitably and adversely impact infrastructure investment. The same conclusion was made by CityFibre in its appeal on the Business Connectivity Market Review. BT therefore cannot be held responsible by Ofcom for the state of investment and competition, when Ofcom's policies defeat their own objective.
13. BT can also not be held responsible for the failure of an Ofcom objective that cannot be achieved. Ofcom states that it wishes to see three or four parallel fixed networks covering at least 40% of premises in the country, based on FTTP deployment. There are no precedents for four parallel fixed access networks in this way in Europe. In fact there are only two instances of three parallel fixed access networks, one in Portugal and one in Spain. For the reasons set out in Section 3 above, the specific market conditions of these countries explain why this outcome arises, particularly because the regulators have focused on passive access and do not mandate wholesale access to the incumbents' fixed fibre access networks. As set out in the Analysys Mason 2016 report, provided with this response, there is no economic case for a parallel fibre network at this scale in the UK, and no evidence has been produced by Ofcom to demonstrate that their goal is viable or an economically rational outcome from UK market conditions. As set out below, Openreach has been providing passive access products in the UK for some time, has a positive relationship with the customers of the products and an agenda of improvements to the products agreed with those customers. However, improved passive access will not solve the problem of parallel network deployment, which is not the passive product set or pricing (as Ofcom themselves acknowledge) but the lack of the economically rational business case. BT cannot be held responsible if Ofcom's ill-judged goal proves to fail as BT and others foresee it will.
14. Fourth, the exceptional nature of Ofcom's Proposals, comprising extremely interventionist regulation, sits at odds with the vagueness of the proposed criteria for success or failure. This lack of specific and quantifiable criteria also

stands in stark contrast to normal (i.e. “non-exceptional”) SMP conditions, such as price controls or Eol obligations, where the actions and behaviour required to be compliant are clearly identifiable.

15. The severity of the proposed intervention, including the suggestion that Ofcom will continue to hold over BT the possibility of imposing full structural separation as a further threat, creates regulatory uncertainty for the whole industry and opens the industry to a permanent state of regulatory gaming. It raises the legitimate expectation for BT (as well as other stakeholders) that the indicators of success must be clear, defined, objective and capable of being measured with a significant degree of certainty. In addition, the lack of guidance on Ofcom’s proposed approach to investigation and enforcement, and clarity on the circumstances in which it would consider there to have been a fail such that it would move to even more extreme forms of regulation, is a fundamental omission from Ofcom’s Proposals. The current proposals fall far short of what is required. For instance, if downstream CPs fail to engage with Openreach when structures are in place to allow them to do so on a confidential basis, or if any engagement fails to identify new commercial opportunities of mutual benefit to both parties, then this cannot automatically be viewed as a failure on BT’s part or of the model itself. In fact, the more logical conclusion to reach – subject to firm evidence to the contrary – is that market outcomes reflect efficient investment and pricing decisions at that time.
16. The proposed measures are also prone to fail through no fault of BT’s. Indeed, for BT, the lack of clarity and certainty on whether it is achieving a specific degree of performance with respect to the various qualitative indicators would inevitably create an additional degree of regulatory uncertainty for itself as well as other stakeholders. This, in turn, cannot be good for investment.³³⁸
17. Fifth, as Ofcom itself acknowledges³³⁹, in some instances BT would be unable to influence the outcomes upon which its performance would be measured because this would be dependent on evidence from third parties.
18. This would be particularly problematic, given that Openreach’s principal customers are CPs who compete with BT downstream in the retail market and, therefore, would have every incentive to allege ongoing difficulties and failures by BT and Openreach in order to use the regulatory process to their commercial benefit. For example, regardless of their network investment strategies, CPs are unlikely to be incentivised to propose plans for co-investment with Openreach if the lack of such proposals would assist them in putting pressure on BT and Openreach, and in promoting their ultimate stated aim of full structural separation. In such a situation, it cannot be seen as appropriate that Openreach’s future could be decided on the basis of the **lack** of co-investment

³³⁸ A further source of radical uncertainty that has arisen since June 2016 is the ongoing political and economic uncertainty arising from the outcome of the EU referendum and its implications for the regulatory environment.

³³⁹ Para. 6.3, July Consultation: *“We recognise that these outcomes are not solely under the control of Openreach, but they are still a critical part of our assessment, since they are the ultimate goal of our intervention.”*

proposals by its competitors, over which Openreach has no control, or, more generally, on the basis of unquantified complaints by those same competitors, which may be the product of regulatory gaming arising from the conditions that Ofcom has produced from the uncertainty and imbalance that its policies have produced.³⁴⁰

19. Sixth, Ofcom already has the ability to deal with any specific concerns around availability, quality, choice and pricing of BT's services in a more proportionate way through its ongoing market reviews and associated normal SMP regulation. For example, service-related issues are already being addressed through minimum service requirements under the existing SMP regime via market reviews, with 100% success to date. In the context of Ethernet and WLR/MPF, additional measures can and are being implemented, with the potential of facing fines for failure to meet these standards and extensive rights for disputes to be raised (or civil claims to be brought) where BT is alleged to be in breach. This normal SMP regime is transparent and gives extensive regulatory protection to all market participants, in contrast to Ofcom's Proposals.
20. Seventh, further improvements within the existing regime are ongoing. These include the implementation of regulations relating to access to civil infrastructure under the Cost Reduction Directive regime that came into force in July 2016, which will assist CPs to deliver any infrastructure investment plans, should they wish to do so. In addition, independently of the outcome of this consultation process, the implementation of the BT Proposal will significantly enhance the independence of Openreach and assist in ensuring improved transparency and responsiveness to its customers' needs.
21. Significant problems therefore exist in relation to Ofcom's suggestions in section 6 of its July Consultation which would need to be rectified in any developed approach to the success of a new model of governance
22. It is important that Ofcom give any new, appropriately-devised model and/or regulatory approach arising out of the DCR time to have an effect in the market and to interpret the results of its monitoring activity within reasonable and relevant time periods. Failure to do so would create the risk that individual

³⁴⁰ The competitive provision of FTTP is clearly dependent on the investment decisions of other industry providers, as well as the suitability of wholesale access products offered by Openreach. The success of a co-investment proposition or new SoR from a CP will be as much down to the extent of any feasible proposals by CPs as it will to Openreach's willingness to agree. In the context of co-investment, it should be noted that a separate change in market circumstances outside of Openreach's influence, including for example new co-investment arrangements between Virgin and third parties, a decision by CityFibre to significantly increase its investment in fibre, or further developments similar to the Sky/TTG initiative in York, could result in "success" in terms of Ofcom's overall policy of increasing investment. However, this could also be portrayed by interested parties as some type of "failure" on the part of Openreach which clearly should not result in further regulatory intervention because Ofcom's investment goals would be achieved.

measures could be interpreted in a way that resulted in a misleading conclusion and increasing uncertainty (to the detriment of the outcomes sought by Ofcom).

23. For example, quite apart from the 'gaming' concern raised above, measuring the success of the model adopted by reference to evidence from customers on the responsiveness of Openreach to new investment ideas could lead to simplistic and misleading interpretations of complex investment decisions as a lack of responsiveness, if considered without context or without establishing an appropriate counter-factual or underlying trend over time.

6.3 Specific comments on the proposed measures

24. As set out above, the measures of success identified by Ofcom in paras. 6.6, 6.7, 6.16 and 6.17 of the July Consultation are mainly qualitative in nature and not capable of being measured with certainty. There is also considerable overlap between them and lack of clarity on how they link to Ofcom's desired outcomes in para. 6.2.³⁴¹
25. We have therefore chosen to provide specific comments along the following themes which are relevant to one or more of the various measures mentioned in Section 6:
- a. Enhancing Openreach's independence;
 - b. Improvement to service levels;
 - c. Improving Responsiveness to customers; and
 - d. Nature and timing of the review and monitoring mechanisms.

6.3.1 Enhancing Openreach independence

26. BT's position is that the existing processes, which were put in place to monitor BT Group's compliance with the Undertakings, have proved successful in ensuring that the regulatory mechanisms introduced to address Ofcom's concerns in 2005 have operated effectively.
27. BT has achieved a successful culture of compliance and the right operational behaviours between Openreach and the rest of the BT Group as a result of a mixture of the following measures:
- a. Senior executive commitment to compliance evident in a top-down compliance culture within the company;

³⁴¹ While the measures of success in para. 6.6 of the July Consultation seem to apply to the Openreach independence outcome in para. 6.2, some of the others, such as the reference to evidence from customers on co-investment models in para. 6.6.2 also apply to what is identified as "industry outcomes" in para. 6.2.

- b. Extensive mandatory training processes, coupled with the code of practice for all employees, and other focused training;
 - c. A culture which is designed to encourage identification and reporting of non-compliant behaviour, and including incentivisation of/reward for the right behaviours and disciplinary process for non-compliance; and
 - d. Compliance leads in each of BT Group's lines of business working into the Group Compliance team to ensure that the environment and processes are in place: the relevant compliance leads are charged with identifying root causes of potential breaches to ensure that they are addressed as soon as possible.³⁴²
28. As set out in Annex D, BT has also ensured adherence to both operational compliance and the culture of compliance through the operation of its Undertakings breach review processes. Where breaches occur, these are reported to the EAB which provides transparency to Ofcom and other CPs by providing details of them in its annual report.
29. Whilst the vast majority of breach investigations are initiated following internal to BT self-reporting, the EAB has also undertaken own-initiative investigations if concerns are brought before it by other CPs.
30. Annex D provides further information in relation to BT's compliance with the Undertakings. It will be seen from this that the breaches have happened for a wide range of reasons. Many of those which occurred over the period in review were due to genuine human error, and/or in circumstances that are unlikely to occur again. A significant proportion did not involve Openreach at all, and of those which did, some were breaches of EoI, and some were not. However, if BT's record of compliance is looked at properly, it is clearly evident that BT has an extremely strong record and culture of compliance, and that BT has never adopted strategies to discriminate in favour of its downstream businesses. BT's record does not suggest that changes to the governance model are needed in order to drive appropriate compliance. Rather, its record of compliance does demonstrate a real commitment to ensuring the success of its equal access and functional separation commitments.
31. The existing monitoring system has also been flexible enough to allow for amendments that were needed as the Undertakings were being implemented and the market developed, allowing for the ability of Ofcom to accept minor changes to the EoI obligation or the internal information barriers so that the regime is workable from a practical perspective.

³⁴² There is regular oversight and audit of Undertakings systems compliance by the EAO and PWC. PWC have not identified any significant issues in relation to inappropriate user access to these systems. The systems compliance programme is managed by Group Compliance to ensure independent integrity over access.

6.3.1.1 BT's Proposal

32. In addition, while BT does not believe Ofcom has made out a case for intervention in the form of virtual structural separation or other form of functional separation going beyond the existing Undertakings, or that any such proposals could be justified as necessary to resolve any alleged strategic discrimination concerns, BT has put forward a proposal to implement an improved model for Openreach governance which has been summarised in detail in Section 5.
33. Given the existence of BT's Proposal, and the clear focus of the July Consultation on Openreach's independence, any measures of success should be limited to BT's implementation of a new governance for Openreach. Such implementation measures would need to be capable of being clearly defined, specific, capable of being measured, and within BT's control.

6.3.2 Improvement to service levels

34. BT agrees that, while service levels have been improving, further improvements in service standards are required at all levels and across the industry³⁴³. Delivering great customer experience has been one of the three main pillars of BT Group's strategy for seven years at least. As outlined in detail in paras. 81 to 89 of Section 3, Openreach has been meeting all of its MSL targets since these have been introduced.
35. Apart from the enhancements to Openreach's independence described above, which specifically relate to BT's Proposal in the context of Ofcom's DCR, BT Group has already made a number of other commitments designed to further develop its service capabilities which were launched in September 2015 and are known as the "Openreach Charter".
36. In terms of progress against these existing commitments, it is worth highlighting that:
- a. Openreach has met or exceeded Ofcom's rising MSLs 2 years and the first half of 16/17;
 - b. Openreach has achieved its own ambition of 95% on time installations overall;

³⁴³ In terms of quality of service outcomes, Ofcom itself acknowledges that end-customer outcomes are dependent on the 'value-add' that retail CPs deliver on top of the Openreach service inputs, as well as the quality of those Openreach inputs. Given the competitive nature of the retail market, Openreach's ability to enhance its own customers' service delivery to final consumers is very limited.

In the case of broadband availability, it should also be noted that there is a major dependency on government policy decisions regarding the scope/funding of a possible broadband USO.

- c. Missed appointments were down by a third and are on track to halve by end of March 2017;³⁴⁴
 - d. 1,250 engineers, including 250 apprentices were recruited in last six months, taking the total to 5,000 over the last 3 years;
 - e. 637 engineers were trained in underground works and 1,000 engineers were also upskilled to deliver new provision. This type of multiskilling is making a difference to both existing staff and new recruits, all of whom are trained to deliver both types of services. BT is also committing additional investment in this context;
 - f. There has been a good start on BT's network health plan by targeting high impact maintenance tasks. So far 32,000 network uplift activities have been completed this year; and
 - g. In the context of Ethernet, in the first quarter this year, Openreach has delivered 7% more circuits than the same period last year and has set itself an additional stretch target to increase these by 20% this year. In order to achieve this, Openreach is investing an additional £30m in its processes, systems and tools in the field, and in reskilling the engineering force.
37. The most recent briefing by Openreach to its customers, delivered on 22 September 2016 and further details of which are set out in Annex B, provides the following information on initiatives intended to deliver better service, broader coverage and faster speeds:
- a. A new Openreach Dashboard (see below) has been launched, providing an aggregated picture of Openreach performance on residential and on business products and including performance against targets that, in some instances, go beyond Ofcom's requirements. For example, the installation and repair measures in the residential space have been set by Ofcom at 89%, BT has decided to now also include fibre as part of this measure.

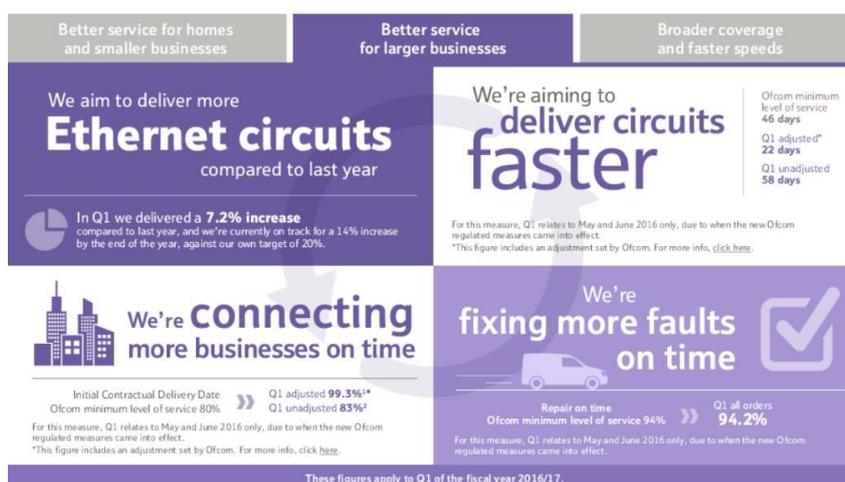
³⁴⁴ It should be noted that missed appointments by other CPs are much higher than those by Openreach and this has been the case for some time.

Fig 6.2.3(i) – slide [4] of Openreach strategy and progress update, 22 September 2016



- b. A new Ethernet Service Dashboard has also been launched providing a range of relevant metrics on Openreach's performance. In this instance the MSLs also go beyond the Ofcom requirements by including actual and Ofcom adjusted metrics and throughput performance.

Fig 6.3.2(ii) – slide [5] of Openreach strategy and progress update, 22 September 2016



- c. The dashboards will also include key measures of the UK's broadband coverage and speeds. In the context of coverage, Openreach intends to:
- i. further extend the superfast footprint, including by doubling BT's FTTP footprint in the next 12 months in order to reach 2m homes and businesses by 2020;³⁴⁵

³⁴⁵ BT's FTTP network already covers over 322,000 premises and BT aims to accelerate that roll out next year in order to reach 2 million homes and businesses by 2020. More details can be found on slide [8] of Openreach strategy and progress update, 22 September 2016.

- ii. drive innovation to take fibre further and provide higher speeds in harder to reach areas, with speeds of at least 10 Megabits to all premises and much higher for 98% of premises (in line with the ambition outlined by the UK Government earlier this year)³⁴⁶; and
 - iii. provide access to BT's duct and pole network to encourage competition and enabling alternative fibre network build.
38. These measures have all been developed to date by Openreach under its current model of governance and SMP regulation. This indicates that any additional measures of success that Ofcom sought to introduce as a result of the change in Openreach governance would need to be distinguished from such existing metrics, to ensure that what is being measured does not simply relate to the underlying service improvements that Openreach is already in the course of implementing.

6.3.3 Improving responsiveness to customers

39. Ofcom's Proposals will defeat the objective that investment decisions at the Openreach level will be more responsive to customers because Openreach will have to make investment decisions without regard to or knowledge of downstream profitability. It will only be able to make investment decisions in isolation, having regard to its own returns and to attempt to build business cases for investment on that basis.
40. The existing regulatory regime of Undertakings and SMP Conditions already requires that Openreach is responsive to customers under the mandated SOR regime and no evidence that this has been unsuccessful has been adduced.
41. The existing monitoring reports, such as the SOR delivery reports provided to Ofcom on a frequent basis, already track Openreach's responsiveness to CPs and no previous breaches related to any type of "strategic discrimination" have been identified in the past.
42. As set out in Section 3 above, even though no evidence has been adduced to demonstrate that the existing regime is not fit for purpose, BT has included in its proposal a new formal confidential process of consultation with CPs in the early stages of significant investment decisions. While this new process, with a higher degree of protection of CPs' information, provides an enhanced process for proposals to be raised and discussed confidentially, including co-investment proposals, existing processes already allow for such possibilities. Yet no well-

³⁴⁶ On 22 September 2016, Openreach launched a new initiative to build FTTP, free of charge, into all new housing developments of 30 or more homes (see slide [8] of Openreach strategy and progress update, 22 September 2016). There are also additional commitments designed to support the Government's 10Meg ambition (referred to as long reach VDSL) which requires cooperation between Openreach and CPs to ensure the technology works with CP's home routers and TV boxes. Openreach is already working with a number of CPs on trials in this context, such as one in Sussex, where VDSL has proved to radically improve speeds to homes as far as two miles from a street cabinet.

developed plans of this nature have in fact been put forward to Openreach in the past.

43. It should be noted that BT has also complied with all of Ofcom's existing Physical Infrastructure Access ("PIA") requirements that have been in place since 2011. They are designed to allow access to Openreach's duct and pole infrastructure to CPs who may wish to deploy their own next generation access networks and offer superfast broadband and telephony services downstream. The implementation of the new duct and pole regime that came into force in July 2016 will also further advance the delivery of any infrastructure investment plans that CPs may have: see further details in Annex E.
44. BT's procedures for PIA, as approved by Ofcom, have recently been overhauled, recently including the following further enhancements designed to encourage more companies to invest, particularly in parts of the UK that are not already served by high-speed networks:³⁴⁷
- a. new rules on faster surveying and building, allowing CPs to inspect Openreach's infrastructure and, if there is space, to install their own fibre immediately without additional permission from Openreach;
 - b. CPs will also be given the authority to clear any blocked ducts they may come across, without needing permission from Openreach;
 - c. given one of the key enablers of network build is the quality of information offered to CPs, Openreach has been working to enhance its database of the nature and location of existing infrastructure so that, by 2017, CPs will have access to the same data as BT itself, which will support CPs that want to take advantage of the liberalised access scheme; and
 - d. CPs will be allowed to install new distribution joints inside Openreach's junction boxes, which will lead to quicker and easier deployment.
45. As noted above, it is essential that any success measures that are introduced are specific to the regulatory measure in question and are objective. Although BT is open to the use of attitude surveys as a tool to assess engagement (and Openreach does carry out CP satisfaction surveys as a current measure of equivalence), there is an obvious risk that subjective measures of this kind can be misleading and uninformative, or worse gamed by those with a vested interest in seeking to prove that things are not working. Such measures should therefore only appropriately be used to supplement more objective measures.
46. Openreach has always been open to developing specific programmes designed to improve customer service for CPs on the basis of their specific requirements. [X

³⁴⁷ Openreach has launched a concept trial in July 2016 which will run until the end of 2016, with five CPs participating, and we're delighted that feedback has been positive so far. So far they have reserved 45 poles, 65km of duct and they have started to lay their own fibre in 51km of that.

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6.3.4 Nature and timing of the review and monitoring mechanisms

47. It should be noted that there are linkages between the agreed timescales for delivery of existing commitments pursuant to SMP regulation and those that may arise in the context of forthcoming market reviews - and in implementation of BT's Proposal. While BT is fully committed to the implementation of these agreed steps, as a general principle the time and resources to be deployed by BT in delivering and monitoring its compliance with regulatory requirements should be proportionate. BT's and Openreach's roadmap for the discharge of any additional regulatory obligations would therefore need to allow for the resources involved in the delivery of multiple (sometimes potentially competing) regulatory requirements or other commitments. It is important to bear those constraints in mind if any new requirements are being considered by Ofcom.
48. The frequency of any reviews also needs to be appropriate. While it is perhaps understandable that Ofcom would want to demonstrate success (or otherwise) to its stakeholders as soon as possible and on a regular basis, we believe there is a limited amount that can be appropriately measured and evaluated on a six-monthly or annual basis.
49. Monitoring on such a short term basis can only be an interim assessment, not the basis of a final assessment. There is a clear risk of a false positive from assessment over too short a period. This risk is compounded by the severity of Ofcom's stated fall-back position of structural separation (which, as BT notes above, an NRA has no power to impose under the ERF):³⁴⁸ in the circumstances, it is imperative that moving to a more extreme form of regulation is warranted, to the requisite legal standard, given the irreversible nature of such a solution. The burden of demonstrating this would firmly be with Ofcom (and ultimately with the courts).
50. Similarly, Ofcom's duties not to impose unnecessary regulation and to operate with a 'bias against intervention' also underline that Ofcom would need to give sufficient opportunity for new governance arrangements to succeed, taking into account all relevant factors. In addition, it would be important to provide certainty to all stakeholders (not least BT) that Ofcom would not seek to re-open any new governance/separation arrangements which are put in place prematurely. If Ofcom sought to revisit the idea of the regulatory regime concerning Openreach, with a view to moving to a more extreme form of separation (and we note that Ofcom "reserves the right" to move to a model based on full structural separation), then it can only do so if it is satisfied that the current model is objectively inadequate, to the requisite standard of proof, based on a clear and comprehensive appraisal of how that is specifically and directly attributable to actions/inactions on the part of Openreach.

³⁴⁸ See Section 2, para. 49.

51. Accordingly, on any perspective, a six-month review period is too short for Ofcom to be able to reach robust, reliable conclusions on the sufficiency or otherwise of the arrangements in place. BT considers that, as a minimum, this period would need to be at least three years, aligned with the normal SMP market review cycle, and more likely longer given the exceptional nature of the regulatory regime relating to functional separation.

6.4 Conclusion

52. The measures of success proposed by Ofcom are inappropriate to deal with the specific concerns of strategic discrimination and lack of FTTP deployment identified as Ofcom's theories of harm in the July Consultation. The measures are unclear, unquantifiable and do not relate in any way to the concerns Ofcom is allegedly seeking to address. They are also inappropriate in determining the effectiveness of Ofcom's Proposals as a form of regulatory intervention, which BT has demonstrated in this submission as unnecessary in the current circumstances in the UK market.
53. The most important of issues, one that BT agrees with, is that of service levels which Openreach has already sought to address on the basis of specific and realistic targets that have been set by reference to customer needs and, in any event, are capable of being subject to regulatory oversight, if necessary. In this context it is worthwhile noting that all of the regulatory targets that have been set by Ofcom in recent years are being met or exceeded as set out in detail in paras. 77 to 90 of Section 3. It is therefore neither necessary nor appropriate to introduce additional measures to deal with service concerns.

SECTION 7 - CONCLUSION

1. In conclusion, the detailed arguments set out in this response can be summarised as follows.
2. The requirements of Art 13a AD for intervention in the form of functional separation have not been met. Contrary to the stated concerns expressed by Ofcom, there is no market failure or important competition problem. In this response, BT has demonstrated:
 - a. The remarkably strong market outcomes in UK fixed line communications;
 - b. The strength of competition in these markets, which are the most competitive or amongst the most competitive in Europe;
 - c. The strength and growth of sustainable competition at the infrastructure level; and
 - d. The success of Ofcom's existing regulatory regime, comprising SMP conditions and the Undertakings, in securing effective competition and in furthering consumers' interests.
3. Ofcom's Proposals are fundamentally flawed, as a result of:
 - a. A deficient theory of harm, which is wholly without foundation;
 - b. The absence of any connection between Ofcom's stated concerns and its Proposals;
 - c. An overreaching remedy which – in Ofcom's Preferred Model – imposes a degree of independence that is akin to virtual structural separation which goes beyond the scope of functional separation remedies imposed under the ERF;
 - d. The failure to conduct proper impact assessment of the costs and possible benefits of its Proposals as compared to a counterfactual scenario;
 - e. The extent of the collateral damage entailed by Ofcom's Proposals for BT, Openreach and the sector as a whole, including but not limited to:
 - i. The negative impact on investments crucial for the UK's digital future;
 - ii. The hugely disproportionate costs imposed as a consequence of incorporation, pensions and transfer of assets and employees as envisaged in its Preferred Model, which are not adequately mitigated in its Alternative Model;
 - iii. Incompatibility with a wide range of other legal, accounting and corporate governance requirements;
 - f. The zero benefits provided Ofcom's Proposals in comparison to BT's voluntary proposal, such that Ofcom's Proposals cannot be the most efficient solution.
4. For all the reasons set out in this response, Ofcom's Proposals give rise to a series of obvious jurisdictional, evidential, theoretical and procedural difficulties that would render it impossible for Ofcom lawfully to proceed. In brief summary,

the statutory requirements of Article 13a AD and ss. 89A and 89B (as elucidated by BEREC in its guidance on the nature of functional separation) are exceptionally stringent, and Ofcom has not come anywhere near to satisfying them. This is not only an insuperable legal difficulty but also reflects the commercial and economic reality, that its proposals are both unnecessary and inappropriate and would represent a disproportionate regulatory intervention.

5. Ofcom, the UK NRA under the ERF and CA03, faces a stark choice:

Either:

- a. To proceed with its proposals along a course that would be bound to fail and would be damaging to the competitive development of the UK market and the interests of consumers if it were to be attempted.

Or:

- b. To consider properly and to accept BT's Proposal, which builds on the existing regulatory structure under CA03 and EA02 that has proved its worth since 2005, while updating it to reflect changes in the market and wider objectives identified by Ofcom in its market review. BT's Proposal is a practical and voluntary way forward that readily provides Ofcom with a comprehensive and proportionate solution to all of its strategic objectives and stated concerns. It is already being introduced and can be implemented, consistently with well understood and tested UK and EU regulatory principles, without further delay.

6. BT therefore respectfully invites Ofcom to accept BT's Proposal. As Ofcom is well aware, BT is fully committed to cooperate with Ofcom in order to resolve the concerns it has stated, even though we do not believe them to be merited, and to further the goals it identified at the start of the review process relating to investment and innovation and competition for the benefit of all customers at all levels of the market. Resolution of the governance issue in a practical and expeditious way will enable all interested parties to move on to these wider issues, to the benefit of competition and end users alike.
7. In the event that, contrary to the detailed reasoning of this response, Ofcom decides to persevere with its own Proposals in the face of the obvious difficulties they face, BT of course reserves all its legal and procedural rights. In particular, were Ofcom to seek to introduce additional evidence or reasoning to address the clear deficiencies in its current proposals in order to meet the evidential thresholds in Article 13a AD and ss. 89A and 89B CA03, or to discharge its statutory duties under EA02, then there would need to be a further period of consultation to allow BT a fair opportunity to comment.