

Compensating providers delivering universal services

Consultation on the funding process and notice of Ofcom's proposal to make funding regulations under section 71 of the Communications Act 2003

[Compensating providers delivering universal services](#) – Welsh overview

CONSULTATION:

Publication date: 5 November 2019

Closing date for responses: 7 January 2020

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1. Overview

We want people across the whole of the UK to be able to access better broadband and mobile phone services, so everyone can benefit from the services they deliver. That means encouraging investment in improved networks and making sure the coverage of networks extends as far as possible – even to the hardest-to-reach places.

A ‘universal service obligation’ (USO) guaranteeing a decent level of home phone services has been in place since 2003. Last year, the Government introduced legislation for a broadband USO, to give homes and businesses the right to request a decent and affordable broadband connection. We welcome this, as an important building block to improving access to broadband services across the UK.

Ofcom is now responsible for implementing the USO within the legal framework that Parliament has agreed. Earlier this year, we appointed BT and KCOM to deliver broadband USO connections and services, and we set the conditions that will apply to them. From 20 March next year, people can start making requests for these services.

The Government has set out that the costs of the broadband USO will be met by industry through a cost-sharing mechanism which will be established by Ofcom.¹ As the ‘Universal Service Providers’, BT and KCOM are entitled to claim any costs that it would not be appropriate for them to cover. In this document, we propose the rules and procedures these providers should follow to make a claim for any unfair cost burden involved in providing universal services. These procedures would apply to the broadband USO, but also to any other universal service obligations.

What we are proposing

- **A Universal Service Provider can request that Ofcom reviews their claim for compensation** for the cost of delivering the USO, minus any benefits associated with being the Universal Service Provider (net cost). We expect to review no more than one net cost claim per year, and it is for Ofcom to decide on the scope of a review and when the review will begin.
- **A Universal Service Provider must submit sufficient information to support their claim for compensation.** For the purposes of the broadband USO, we also propose to separately require the provider to submit specific financial information.
- **When carrying out a review, Ofcom will need to determine the existence and level of any net cost.** We will review the information submitted by the provider and assess whether the costs incurred in delivering the USO were efficient. Our calculation will also be audited.
- **Once we determine a net cost, we will decide whether it would be unfair for the provider to bear some or all of that cost.** We propose our approach which includes considering: the cost to Ofcom and industry of establishing and administering an industry fund; the impact on the provider of bearing these costs alone; the method of designating the Universal Service Providers; and the outcome of any previous determinations.

¹ DCMS, March 2018. [A new broadband Universal Service Obligation: Government’s response to consultation on design](#), page 5.

- **If we decide that delivering the USO is an unfair burden, Ofcom may establish an industry fund to compensate the Universal Service Providers.** We will also determine who will contribute to the fund and how much they will contribute. This will include any threshold below which contributions will not be required.
- **Once we have established an industry fund, we will collect monies from industry and compensate the Universal Service Provider.** We will gather and check relevant information to calculate individual contributions. We will then invoice each provider required to contribute to pay by a specified deadline. When we start receiving the contributions, we will pay the Universal Service Provider on a monthly basis.

Next steps

We are seeking views and comments on our proposals by 5pm on 7 January 2020. Following this consultation period, we plan to publish a statement in spring 2020.

The Universal Service Providers are currently preparing to deliver the broadband USO and consumers will be able to start requesting a broadband USO connection from 20 March 2020.

2. Introduction

- 2.1 The universal service is intended to ensure that people can access a minimum set of communications services at an affordable price. It acts as a ‘safety net’ for people who might otherwise get left behind and suffer social or economic disadvantage without access to these services.
- 2.2 The universal service is implemented by imposing a universal service obligation (“USO”) on providers. The USO placed on BT and KCOM to guarantee a decent level of telephony services is a longstanding feature of the UK telecoms framework. The most recent designations in relation to universal service were made for broadband.
- 2.3 This follows legislation the Government introduced in March 2018 for a broadband ‘universal service obligation’ (“the broadband USO”), to give homes and businesses the right to request a decent and affordable broadband connection.² The legislation states that affordable broadband connections and services must be provided throughout the UK with a download speed of at least 10 megabits per second (“Mbit/s”) and other specified technical characteristics.³
- 2.4 As part of Ofcom’s role in implementing the broadband USO, in June 2019 we designated BT and KCOM as Universal Service Providers. Both are now subject to universal service conditions that will apply to them as they deliver broadband USO connections and services. From March next year, consumers will be able to request a connection from BT and KCOM if they do not have access to decent, affordable,⁴ broadband.
- 2.5 Universal Service Providers can seek compensation for any unfair financial burden to which they are subject as a result of the universal service conditions imposed upon them. In this document we are consulting on making The Electronic Communications (Universal Service) (Costs) Regulations 2020 which set out the proposed rules and procedures we will follow when assessing any net costs of the provision of a universal service and, where appropriate, compensating the Universal Service Provider for those costs. This is in accordance with our previous commitment to consult on these draft funding regulations during autumn 2019.
- 2.6 The draft funding regulations are not specific to the broadband USO. They are proposed to apply to costs incurred in connection with all present universal service conditions as well as universal service conditions which may be imposed in the future. In our view, having one generally applicable set of funding regulations is preferable to creating a complex regulatory framework comprising different sets of funding regulations for different sets of

² [The Electronic Communications \(Universal Service\) \(Broadband\) Order](#) came into force on 23 April 2018.

³ The Digital Economy Act 2017 introduced legislative amendments to section 65 of the Communications Act 2003 which allow for the inclusion of broadband connections and services in a universal service order. See the inserted sub-section 65(2B) of the Act.

⁴ Universal Service Providers must offer connections and services at the same prices as equivalent services they offer to non-USO customers. BT has also committed to offering at least one broadband connection and service that meets the USO specification at no more than £45 per month.

universal service conditions. We anticipate that it will be more straightforward and less burdensome for both those likely to be affected by the funding regulations and for us to work with a single regulatory framework. The draft funding regulations have, therefore, been drafted with a broad application in mind.⁵

Our work on improving broadband coverage

- 2.7 Improving broadband coverage is an important strategic aim for both us and the Government. One of the means by which we aim to secure decent broadband for consumers in the hardest-to-reach parts of the UK is through the broadband USO.
- 2.8 As part of our role in implementing the broadband USO, we have put in place the regulations and conditions related to the designation of Universal Service Providers. A summary of how we did this is provided below:
- a) In June 2018, we published *Implementing the Broadband Universal Service Obligation: Request for expressions of interest in serving as Universal Service Provider for broadband* (“the June 2018 document”).⁶ We set out our objectives for implementing the broadband USO, explaining that our approach must, above all, serve the interests of consumers. We explained how we would designate the Universal Service Provider(s) and provided an early indication of the obligations and expectations we would place on these provider(s). We invited interested stakeholders to express interest in being designated as a Universal Service Provider, either on a national or sub-national basis.⁷
 - b) In September 2018, we published *Implementing the Broadband Universal Service Obligation: Consultation on designation regulations* (“the September 2018 consultation”).⁸ Following consideration of the relevant expressions of interest and responses to the June 2018 document, we consulted on draft designation regulations and proposed that direct designation was the quickest and most effective process to determine who should be the Universal Service Provider(s) for the broadband USO.
 - c) In December 2018, we also published *Delivering the Broadband Universal Service: Proposals for designating providers and applying conditions* (“the December 2018 consultation”).⁹ We explained our assessment of the eight expressions of interest we received in being a Universal Service Provider which led us to propose to designate BT and KCOM to deliver the broadband USO. We also set out proposals on the obligations we would impose on them. We made The Electronic Communications (Universal

⁵ We recognise that circumstances may arise in future which necessitate amendments to the funding regulations or a new and separate set of regulations applicable to costs incurred in respect of different universal service conditions.

⁶ Ofcom, June 2018. [Implementing the Broadband Universal Service Obligation: Request for expressions of interest in serving as Universal Service Provider for broadband.](#)

⁷ The eight providers that expressed an interest in being a Universal Service Provider were Airband, Bentley Walker, Broadway Partners, BT, Hyperoptic, KCOM, Quickline and Viasat.

⁸ Ofcom, September 2018. [Implementing the Broadband Universal Service Obligation: Consultation on designation regulations.](#)

⁹ Ofcom, December 2018. [Delivering the Broadband Universal Service: Proposals for designating providers and applying conditions.](#)

Service) Regulations 2018 setting out the direct designation process by which providers would be designated.

- d) In June 2019, we published *Delivering the Broadband Universal Service: Designating Universal Service Providers and setting conditions* (“the June 2019 statement”).¹⁰ We set out our decision to designate BT and KCOM as the Universal Service Providers and imposed conditions on them to ensure everyone can access decent, affordable broadband services within a reasonable timeframe and receive services as good as those available elsewhere in the UK.

Number of premises that could benefit from the USO

- 2.9 As commercial and publicly-funded network rollout continues, the number of premises that cannot get decent broadband continues to fall from 15% in 2014¹¹, to 6% in 2016¹² and 2% in September 2019.¹³ Our most recent *Connected Nations* report shows that this figure is currently around 578,000 premises, before taking into account Fixed Wireless Access (“FWA”) services. FWA has the capability to connect a significant number of these premises. We expect this figure will fall further when we complete our work to include the coverage of all major fixed wireless networks in our next *Connected Nations* report in December 2019.
- 2.10 At the time of the June 2019 statement, BT considered it would be able to connect 450,000 premises using its commercial fixed wireless product, and that 110,000 premises would cost above the reasonable cost threshold to connect, leaving 40,000 premises likely to be eligible for the broadband USO. BT’s projections on the likely number of eligible premises have evolved due to several factors, including the expansion of its own FWA coverage and continued fibre rollout. BT now considers even fewer premises to be eligible by the time the broadband USO comes into effect in March 2020.
- 2.11 KCOM stated that it planned to deliver Fibre to the Premises (“FTTP”) to all premises in the Hull area and that the majority would be delivered before the broadband USO comes into effect.
- 2.12 As the number of eligible premises has continued to fall, so has the likely cost of delivering the broadband USO.

Purpose of this document

- 2.13 We are now consulting on the draft funding regulations which set the framework for the funding process. This includes the procedures the Universal Service Providers and Ofcom will follow should a request for compensation be made, it also provides guidance on how

¹⁰ Ofcom, June 2019. [Delivering the Broadband Universal Service: Designating Universal Service Providers and setting conditions](#).

¹¹ Ofcom, December 2014. [Infrastructure Report 2014](#), page 2. This figure represents 15% of UK households cannot receive 10 Mbit/s.

¹² Ofcom, December 2017. [Connected Nations Report 2017](#), figure 2.

¹³ Ofcom, September 2019. [Connected Nations Update: Summer 2019](#), page 1.

we envisage approaching the review of any net cost claim submitted by the Universal Service Provider and compensating the Universal Service Provider for any unfair cost burden. We are consulting on a detailed set of processes in this area for the first time and therefore suggest the draft legal instrument set out in [Annex 5](#) is considered alongside the consultation document which summarises its content. This document therefore provides formal notice to stakeholders of our intention to make funding regulations and sets out their general effect.

2.14 In addition, we are also consulting on:

- a) regulatory financial reporting directions for BT and KCOM under the broadband universal service conditions F3.¹⁴ The proposed obligations contained in the directions will require the Universal Service Providers to supply information to us to support any request to review a net cost claim;
- b) formal guidance on the calculation of net relevant turnover for the purposes of calculating the amount of any contributions that are due to an industry fund.

Next steps

2.15 We ask for views and comments on the proposals in this document by 5pm on 7 January 2020. Following this consultation period, we plan to publish a statement in spring 2020.

Rest of this document

2.16 The rest of this document is structured as follows:

- **Section 3** sets out the legal framework for funding of the universal services;
- **Section 4** sets out our proposed procedures for assessing a net cost claim;
- **Section 5** sets out how we propose to calculate and verify a net cost;
- **Section 6** sets out how we propose to determine if a net cost is unfair;
- **Section 7** sets out the proposed design of an industry fund and who contributes to it;
- **Section 8** sets out the proposed procedures for the collection and distribution of contributions to an industry fund; and
- **Section 9** sets out the requirements proposed in separate regulatory financial reporting directions which are designed to support a net cost assessment in relation to the broadband USO.

¹⁴ See the June 2019 statement, [Annex 1 Legal instruments](#), page 15.

3. Legal framework

Introduction

- 3.1 In this section we set out the legal framework applicable to making funding regulations and subsequent decisions under those regulations in respect of a claim for compensation for any unfair financial burden arising from delivering a universal service.
- 3.2 Universal service means the provision of a defined minimum set of services of specified quality which is available to all consumers at an affordable price.¹⁵ The purpose of a universal service is to act as a safety net where market forces alone do not deliver affordable access to such minimum set of communications services.
- 3.3 The requirement to secure universal service in the UK currently derives from the Universal Service Directive which has been implemented into UK law through the Communications Act 2003 (“the Act”) and secondary legislation. The scope of the universal service, specifying the minimum set of services that must be provided to secure compliance with the Universal Service Directive, is determined by the Secretary of State by making an order under section 65 of the Act. To date, the Secretary of State has made the following orders under section 65 of the Act.
- a) The Electronic Communications (Universal Service) Order 2003 (“the 2003 Order”) which set out that publicly available telephone services and other specified services (together “the telephony universal service”) must be provided, made available or supplied throughout the UK; and
 - b) The Electronic Communications (Universal Service) (Broadband) Order 2018 (“the 2018 Order”) which extended the universal service to broadband connections and services of specified quality (together “the broadband universal service”).¹⁶
- 3.4 Ofcom’s role is to implement any order under section 65 of the Act to secure, as far as practicable, the universal service. In doing so, we must designate providers who will act as Universal Service Provider(s) and be subject to universal service conditions which set out how the provision of the universal service is to be achieved. We implemented the 2003 and 2018 Orders by designating KCOM and BT as the Universal Service Providers to deliver each of the telephony universal service and the broadband universal service in the Hull area and the rest of the UK respectively. We decided that it was appropriate to use a direct designation process in those cases rather than a competitive process.

¹⁵ See the definition of universal service contained in Article 2(j) of Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services as amended.

¹⁶ The technical specification of the broadband universal service in the 2018 Order includes a download sync speed of at least 10 megabits per second; an upload sync speed of at least one megabit per second; a contention ratio of no higher than 50:1; latency which is capable of allowing the end-user to make and receive voice calls over the connection effectively; and the capability to allow data usage of at least 100 gigabytes per month.

- 3.5 Universal Service Providers may be compensated for the costs of delivering a universal service. The legislation provides that a net cost of providing a universal service can be compensated where it is established that such a net cost represents an unfair burden on a Universal Service Provider. In the UK, Ofcom is responsible for calculating the net cost of providing a particular universal service and determining whether and if so, to what extent, that net cost represents an unfair burden on a Universal Service Provider. Where an unfair burden is found, the Universal Service Provider must be compensated through one of the following mechanisms: (i) public funds; (ii) an industry fund established by Ofcom; or (iii) a combination of public and industry funding.
- 3.6 The legislation outlines the way in which the various steps of the funding process should be carried out. Ofcom is given discretion to decide how the funding process should operate in practice and what rules and procedures should apply to that process. The Act empowers Ofcom to make regulations which must specify the rules and procedures that Ofcom considers appropriate. Any subsequent funding assessment needs to be undertaken in accordance with those regulations.
- 3.7 The European Electronic Communications Code (“the Code”), which was adopted by the European Parliament and the Council of the European Union on 11 December 2018, replaces (among other things) the Universal Service Directive with effect from 21 December 2020.¹⁷ The Government indicated in July 2019 that its intention was to implement the Code in full into the UK’s law by 21 December 2020¹⁸, although this may be affected by the terms on which the UK withdraws from the European Union, which are uncertain at present. In any event, we note that the Code does not introduce many changes relevant to funding of the universal service¹⁹ so the implementation of the Code is unlikely to affect materially this aspect of our work on the universal service.²⁰
- 3.8 The rest of this section sets out the legal framework applicable to both making funding regulations and subsequent decisions under those regulations in respect of a particular net cost claim. When explaining Ofcom’s role in respect of funding of the universal service, we explain the following:
- a) the legislative provisions and the principles established by caselaw which are relevant to each stage of the funding process;
 - b) the duties to which Ofcom must have regard in fulfilling its role under the legislation in respect of the funding process;
 - c) the content and consultation requirements in respect of funding regulations;
 - d) a summary of the obligations the legislation imposes on Ofcom with respect to reporting on the funding of the universal service; and

¹⁷ Article 125 of the Code.

¹⁸ DCMS, July 2019. [Implementing the European Electronic Communications Code](#), page 5.

¹⁹ Please note a change to the definition of Electronic Communications Service made by the Code which we explain in Section 7.

²⁰ The provisions of the Universal Service Directive relating to the universal service have been replaced in the Code by Articles 84 to 92 and Recitals 210 to 245.

- e) Ofcom's duties in respect of the carrying out of impact assessments.

Legislative provisions and principles

- 3.9 The main stages of the funding process are set out below.
- a) Ofcom may calculate a net cost (if any) of complying with particular universal service conditions.
 - b) Where Ofcom concludes that a net cost exists, Ofcom must determine whether it would be unfair for the Universal Service Provider to bear some or all of that net cost.
 - c) The Universal Service Provider may apply to Ofcom for a determination that there should be an industry fund to compensate it for an unfair net cost burden.
 - d) Where Ofcom receives such an application, it must determine whether there should be an industry fund having regard to whether public funds are to be used to compensate the Universal Service Provider for the whole or part of an unfair net cost burden.
 - e) Where Ofcom has determined that an industry fund should be set up, Ofcom must determine who is liable to contribute to the fund.
 - f) Ofcom, or the independent body Ofcom appoints to administer the fund, will proceed to collect and distribute the industry contributions.

Calculating a net cost of complying with particular universal service conditions

- 3.10 The legislation provides that a net cost of providing the universal service must be calculated using one of the following bases as applicable:
- a) where designation of Universal Service Providers is undertaken through a process which takes account of the net cost of complying with the universal service conditions to be imposed, the particular method of performing the calculation which has been used in the designation process must then be used when performing the calculation as part of the funding process;²¹ and
 - b) where such a process has not been used,²² the net cost of providing the universal service must be calculated by subtracting market benefits accruing to a Universal Service Provider from the costs incurred in delivering the universal service.²³
- 3.11 The legislation sets out additional principles for calculating a net cost which the national regulatory authorities should have regard to (in addition to other principles they may identify as relevant).

²¹ Section 70(2) of the Act.

²² As explained above, Ofcom decided that it was appropriate to use a direct designation process when designating BT and KCOM to provide the telephony and broadband universal service.

²³ Section 70(3) of the Act.

- a) The net costs must be calculated as the difference between the net cost for a designated undertaking of operating with the universal service obligations and operating without the universal service obligations.²⁴
- b) The calculation should take due account of costs and revenues, as well as the intangible benefits (such as an increase in brand value) resulting from providing the universal service but should not hinder the general aim of ensuring that pricing structures reflect costs.²⁵
- c) In relation to costs, due attention is to be given to correctly assessing the costs that a Universal Service Provider would have chosen to avoid had there been no universal service.²⁶
- d) In relation to intangible benefits, taking them into account means that an estimate in monetary terms, of the indirect benefits that an undertaking derives by virtue of its position as provider of universal service, should be deducted from the direct cost of the universal service in order to determine the overall cost burden.²⁷
- e) The calculation should be based upon the costs attributable to: (i) elements of the identified services which can only be provided at a loss or provided under cost conditions falling outside normal commercial standards;²⁸ (ii) specific end-users or groups of end-users who, taking into account the cost of providing the specified network and service, the revenue generated and any geographical averaging of prices imposed by the national regulatory authority, can only be served at a loss or under cost conditions falling outside normal commercial standards.²⁹
- f) The calculation should be made separately and so as to avoid the double counting of any direct or indirect benefits and costs; the overall net cost of the universal service to any undertaking is to be calculated as the sum of the net costs arising from the specific components of universal service obligations, taking account of any intangible benefits.^{30 31}
- g) Any net cost of the universal service should be calculated on the basis of transparent procedures.³²

²⁴ Part A of Annex IV of the Universal Service Directive.

²⁵ Part A of Annex IV and Recital 19 of the Universal Service Directive.

²⁶ Part A of Annex IV of the Universal Service Directive.

²⁷ Recital 20 of the Universal Service Directive.

²⁸ This category may include service elements such as access to emergency telephone services, provision of certain public pay telephones, provision of certain services or equipment for disabled people as set out in Part A of Annex IV of the Universal Service Directive.

²⁹ This category includes those end-users or groups of end-users which would not be served by a commercial provider which did not have an obligation to provide universal service as set out in Part A of Annex IV of the Universal Service Directive.

³⁰ Part A of Annex IV of the Universal Service Directive.

³¹ The principles outlined in paragraphs 3.11(a) to 3.11(f) should be taken into consideration where designation of Universal Service Providers is undertaken through a process which does not take account of the net cost of providing the universal service.

³² Recital 19 of the Universal Service Directive.

Auditing the net cost calculation

- 3.12 The net cost calculation must be audited either by us or by a person who appears to us to be independent of the Universal Service Providers.³³ We are also required to ensure that a report of the audit is prepared and a summary of that report is published.³⁴

Assessing unfairness

- 3.13 Where we conclude that a net cost exists, we are required to consider whether it would be unfair for the Universal Service Provider to bear all or part of that net cost.
- 3.14 The Universal Service Directive provides that a compensation mechanism should, where necessary, be established where it is demonstrated that the universal service obligations can only be provided at a loss or at a net cost which falls outside normal commercial standards.³⁵ However, as observed by the European Court of Justice,³⁶ in concluding that the net cost of the universal service does not necessarily represent an unfair burden for all the undertakings concerned, the Universal Service Directive intended to exclude the possibility that any net cost automatically gives rise to a right to compensation.³⁷
- 3.15 The legislation does not define the concept of unfair burden or specify how the national regulatory authorities should approach the unfairness assessment but some guidance has been given by the European Court of Justice.³⁸ It explained that the unfair burden is a burden which, for each undertaking concerned, is excessive in view of the undertaking's ability to bear it, account being taken of all the undertaking's own characteristics such as the quality of its equipment, its economic and financial situation and its market share.³⁹
- 3.16 The European Court of Justice emphasised that consideration of unfairness requires the national regulatory authority to carry out an individual assessment of the particular situation of the Universal Service Provider. That assessment must be conducted in light of the criteria laid down by the national regulatory authority, taking account of the Universal Service Provider's relevant characteristics and circumstances prevailing at the time of the assessment.⁴⁰

³³ Section 70(4) of the Act.

³⁴ Section 70(6)(b) of the Act.

³⁵ Recital 18 of the Universal Service Directive.

³⁶ The judgments of the European Court of Justice (as it then was) in the following cases: (i) *European Commission v Kingdom of Belgium* C-222/08 (the [judgment](#) is available); and (ii) *Base NV and Others v Ministerraad* C-389/08 (the [judgment](#) is available). Both cases concerned the same legislation passed by the Belgian Parliament which acted as the national regulatory authority responsible for determining whether an unfair burden existed as a result of the universal service. The cases were considered by the same chamber of the European Court of Justice (the [judgment](#) is available).

³⁷ Paragraphs 48 and 49 of the judgments in cases C-222/08.

³⁸ The judgments in case C-222/08 and C-389/08 referred to above.

³⁹ Paragraph 49 of the judgments in cases C-222/08.

⁴⁰ Paragraph 50 of the judgments in cases C-222/08.

Compensating for an unfair burden

- 3.17 As set out above, where we determine that an unfair net cost burden exists, such burden must be compensated through one of the following mechanisms: (i) public funds⁴¹; (ii) an industry fund to which providers of Electronic Communications Networks (“ECN”) and/or Electronic Communications Services (“ECS”)⁴² contribute;⁴³ or (iii) a combination of public and industry funding.⁴⁴
- 3.18 We have the power to set up an industry fund where:
- a) we have determined that there is an unfair net cost burden; and
 - b) the Universal Service Provider has applied to us for a determination that contributions should be made by other communications providers.⁴⁵
- 3.19 The legislation gives us discretion to decide how the compensation process should operate in practice and what rules and procedures should apply to that process. The set of rules and procedures which we consider appropriate must be set out in regulations made by us. Once the regulations are made, each industry fund that is required will then be established and administered in accordance with the compensation mechanisms provided for in those regulations.⁴⁶
- 3.20 When making those regulations and subsequent decisions in individual cases under those regulations, we must seek to secure that the rules and procedures required to establish and administer an industry fund respect the principles of transparency, proportionality, no undue discrimination and least market distortion. In considering no undue discrimination, we need to ensure that the rules and procedures are carried out in a manner that we consider does not involve, or tend to give rise to, any undue discrimination against particular communications providers or particular Universal Service Providers, or against a particular description of them.⁴⁷
- 3.21 The principles of transparency, proportionality and no undue discrimination are general principles of the EU law. The principle of least market distortion does not have a similar status in EU law as the other principles. Instead, it is a principle which has been identified as particularly relevant to the framework for the universal service, as explained in the Universal Service Directive. There is no hierarchy between these four principles set out in the legislation. In fulfilling our functions under the Act, we must therefore strike a balance, which we consider gives appropriate weight to each of those principles in light of particular circumstances of each case.

⁴¹ Recital 22 of the Universal Service Directive states that public funds should be understood to comprise “funding from general government budgets including other public funding sources such as state lotteries.”

⁴² ECN and ECS are defined in section 32 of the Act.

⁴³ Recital 21 to the Universal Service Directive refers to this as “recovering net costs from all users in a transparent fashion by means of levies on undertakings.”

⁴⁴ Article 13(1) of the Universal Service Directive.

⁴⁵ Section 71(3) of the Act.

⁴⁶ Section 71(5) of the Act.

⁴⁷ Section 71(6) of the Act and Article 13(3) of the Universal Service Directive.

3.22 We explain how we understand each of those principles below.

Transparency

3.23 Transparency encompasses a number of features which focus on ensuring that sufficient information is provided, including explaining why a particular approach has been chosen and how competing considerations have been evaluated. We also consider that the complexity of a particular approach is relevant to securing transparency. For example, if an approach is so complicated that it cannot readily be understood, then it is unlikely to be transparent.

Proportionality

3.24 Proportionality requires that the means used to achieve a given end must be no more than that which is appropriate and necessary to achieve that end. It follows that ensuring a particular approach is proportionate involves considering potential alternatives.

No undue discrimination

3.25 The principle of no undue discrimination requires that similar situations must not be treated differently unless there is an objectively justifiable reason for doing so. In applying this principle, we think that it is necessary to decide whether persons are similarly situated such that a difference in treatment is discriminatory, and whether that difference in treatment can be justified.

Least market distortion

3.26 The Universal Service Directive requires us to secure that contributions are recovered in a way that as far as possible minimises the impact of the financial burden falling on end-users, for example by spreading contributions as widely as possible.⁴⁸

3.27 As explained above, we must have regard to the least market distortion principle alongside the remaining principles when deciding what rules and procedures we should include in the funding regulations and when making subsequent decisions in individual cases under those regulations. However, by placing a duty on us to 'minimise the impact' it is implicitly accepted that some market distortion may be an inevitable consequence of establishing a sharing mechanism under the funding regulations to compensate the Universal Service Provider for an unfair net cost burden.

Other requirements applicable to compensating for an unfair burden

3.28 The principles of transparency, proportionality, no undue discrimination and least market distortion must be considered and respected at each stage of assessing, collecting and distributing contributions, namely choosing who should contribute to an industry fund and

⁴⁸ Recital 23 of the Universal Service Directive.

in what proportions. The legislation contains additional requirements in respect of each of those aspects as explained below.

Choosing who should contribute to an industry fund

- 3.29 We are tasked with deciding which providers should contribute to an industry fund in accordance with the following rules.
- a) Contributions may only be sought from undertakings who are subject to the general conditions,⁴⁹ that is, those providing ECN and/or ECS, for example, providers of fixed and/or mobile networks.
 - b) Contributions cannot be sought from undertakings that are not providing services in the UK.⁵⁰
 - c) We may choose not to require contributions from undertakings whose national turnover is less than a set limit. For example, we may exempt new entrants which have not yet achieved any significant market presence.⁵¹

Deciding how much each contributor should pay

- 3.30 The legislation requires that contributions are collected in a transparent and neutral way which avoids the risk of the double imposition of contributions falling on both outputs and inputs of undertakings.^{52 53} We are also required to ensure that any charges related to the sharing of the cost of the universal service must be unbundled and identified separately for each undertaking.⁵⁴

Collecting and distributing contributions

- 3.31 An industry fund must be administered either by the national regulatory authority or another body which is independent of the Universal Service Providers and other providers to whom general conditions apply.⁵⁵ The role of that body is to collect contributions and oversee the transfer of all sums due to the Universal Service Providers who are entitled to receive payments from the fund.⁵⁶

⁴⁹ Section 71(3) of the Act.

⁵⁰ Article 13(4) of the Universal Service Directive provides that contributions shall not be sought from undertakings that are not providing services in the territory of the Member State that has established an industry fund.

⁵¹ Article 13(3) of the Universal Service Directive.

⁵² Annex IV of the Universal Service Directive.

⁵³ The double imposition of contributions might occur, for example, if a retailer purchases wholesale inputs from another undertaking (e.g. a network operator) on which contributions have already been collected, and contributions are collected again when the retailer sells those products to end-users.

⁵⁴ Article 13(4) of the Universal Service Directive.

⁵⁵ Sections 70(7) and 70(8) of the Act. It should be noted that if the scheme is to be administered other than by Ofcom, Ofcom must specify the person who will administer the scheme in the funding regulations.

⁵⁶ Part B of Annex IV of the Universal Service Directive.

Ofcom's duties

- 3.32 In addition to the statutory requirements set out above, in fulfilling its role under the legislation in respect of funding of the universal service, Ofcom must have regard to its duties under the Act. In particular, we must consider our principal duty to further the interests of citizens in relation to communications matters and the interests of consumers in relevant markets, where appropriate by promoting competition.⁵⁷
- 3.33 In performing those duties, Ofcom must have regard to objectives set out in section 3(4) of the Act as they appear relevant to Ofcom in the circumstances. We consider the following objectives to be relevant to fulfilling our role in relation to funding of the universal service:
- a) the desirability of promoting competition in relevant markets;
 - b) the desirability of encouraging investment and innovation in relevant markets; and
 - c) the desirability of encouraging the availability and use of high-speed data transfer services throughout the UK.
- 3.34 Ofcom must also act in accordance with the six Community requirements of which the following are particularly relevant:
- a) promoting competition;
 - b) promoting the interests of EU citizens; and
 - c) carrying out our functions in a manner which, as far as practicable, does not favour one form of network, communications service or associated facility; or one means of providing or making available such a network, service or facility.⁵⁸

Content and consultation requirements applicable to making funding regulations

- 3.35 The Act requires Ofcom to consult on proposed regulations with those who in Ofcom's opinion are likely to be affected by the regulations. The consultation period must be of at least one month.
- 3.36 We set out the draft funding regulations that Ofcom proposes to make at [Annex 5](#). These regulations set the framework for the funding process including:
- a) the process Ofcom would follow before determining: the net cost of complying with the relevant universal service conditions; whether it would be unfair for a Universal Service Provider to bear the net cost of compliance; and, if there is to be an industry fund to compensate the Universal Service Provider, who should contribute to that fund;
 - b) how the contributions to an industry fund would be determined; and

⁵⁷ Section 3(1) of the Act.

⁵⁸ Section 4 of the Act.

- c) how an industry fund would operate in practice (for example, how funds would be collected and distributed).
- 3.37 The general effect of the provisions of the proposed funding regulations is described in Sections 5-8 of this document.

Reporting on the compensation mechanism

- 3.38 The Act prescribes that, once funding regulations have come into force, Ofcom must publish a report which sets out for the period for which it covers:
- a) any determinations of net costs made;
 - b) the market benefits which have accrued to each Universal Service Provider as a result of being designated and subject to universal service conditions; and
 - c) details of the contributions made by each contributor to any industry fund.⁵⁹
- 3.39 The first report must cover the twelve-month period after the coming into force of the funding regulations. There must then be further reports to cover each subsequent twelve-month period.⁶⁰
- 3.40 Ofcom is required to prepare each report as soon as practicable after the end of the period to which it relates and must publish the report as soon as practicable after its preparation.⁶¹ Reports on compensation mechanisms are not required to contain any confidential information.⁶² In preparing and publishing those reports, Ofcom will have regard to its duties and powers in respect of disclosure under section 393 of the Act.

Impact assessment

- 3.41 The analysis presented in this consultation constitutes an impact assessment as defined in section 7 of the Act.
- 3.42 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the Act, which means that generally we have to carry out impact assessments where our proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in our activities. However, as a matter of policy, we are committed to carrying out impact assessments in relation to the great majority of our policy decisions.⁶³

⁵⁹ Section 72(2) of the Act.

⁶⁰ Sections 72(3) and 72(4) of the Act.

⁶¹ Section 72(5) of the Act.

⁶² Section 72(6) of the Act. Confidential information is defined for these purposes in sections 72(7) and 72(8) of the Act.

⁶³ For further information about our approach to impact assessments, see the guidelines: [*Better policy-making: Ofcom's approach to Impact Assessment.*](#)

Equality impact assessment

- 3.43 Ofcom is separately required by statute to assess the potential impact of all our functions, policies, projects and practices on race, disability and gender equality. Equality Impact Assessments (“EIAs”) also assist us in making sure that we are meeting our principal duty of furthering the interests of citizens and consumers regardless of their background or identity.
- 3.44 It is not apparent to us that the proposals set out in this consultation are likely to have any particular impact on race, disability and gender equality. Specifically, we do not envisage the impact of any outcome to be to the detriment of any group of society. Nor do we envisage any need to carry out separate EIAs in relation to race or gender equality or equality schemes under the Northern Ireland and Disability Equality Schemes. This is because our proposals contained in this consultation seek to set an appropriate framework for the funding process, including reviewing any net cost claim submitted by the Universal Service Provider and compensating the Universal Service Provider for any unfair cost burden. This work therefore forms part of our duty to implement the universal service in order to ensure that all eligible consumers, irrespective of their race, disability, gender, income or the part of the UK they live in, can benefit from the universal service on reasonable request.

4. Requests for a review and determining a net cost claim

- 4.1 The Act empowers Ofcom to commence a review of the extent, if any, of the financial burden of complying with one or more of the universal service conditions applied to a particular Universal Service Provider. The Universal Service Provider is likely to be first to identify a potential unfair financial burden. If a Universal Service Provider believes that compliance with the universal service conditions creates an unfair financial burden, it may wish to ask us to commence a review.
- 4.2 In this section, we provide an overview of:
- a) the proposed considerations Ofcom will have regard to when deciding whether to commence a review of a net cost;
 - b) the proposed approach to when and how the Universal Service Provider can request that Ofcom commences a review of a net cost;
 - c) the proposed approach to when and how the Universal Service Provider can request that Ofcom set up an industry fund to compensate it for any unfair net cost;
 - d) the procedural steps Ofcom will follow when determining:
 - i) the level of the net cost incurred by the Universal Service Provider;
 - ii) whether it would be unfair for the Universal Service Provider to bear some or all of these costs; and
 - iii) that an industry fund should be set up to compensate the Universal Service Provider, should that be appropriate.

Requesting that Ofcom review a net cost of compliance

- 4.3 The Universal Service Provider will be able to make a judgement about what point in the process of fulfilling its universal service conditions, it should ask Ofcom to review a net cost of complying with those conditions. In particular, it will be able to consider when it has sufficient information to enable it to provide details of the costs incurred and explain why, in its view, these represent an unfair financial burden. It is, however, for Ofcom to decide whether it will commence a review, and the scope of that review.
- 4.4 The Universal Service Provider should ensure its request to commence a review contains the information required to enable Ofcom to undertake an assessment of a net cost.

Considerations when deciding whether to commence a review of a net cost

- 4.5 In deciding whether to undertake the review, we will need to consider all of the relevant circumstances, including:

- a) if there is enough information to commence the calculation and verification of a net cost effectively and to carry out a proper assessment of the potential unfairness of the Universal Service Provider bearing a financial burden of complying with the universal service conditions. This will include ensuring the Universal Service Provider has provided the required information set out in Section 5 and Section 9; and
 - b) whether the potential size of the net cost is proportionate to the work involved in assessing the application and, potentially, setting up an industry fund.
- 4.6 Where we receive a request for review from the Universal Service Provider, we may accept the request to commence a review, decline to commence a review, or to commence a review which is different in scope to what the Universal Service Provider has proposed. We will notify the Universal Service Provider in writing of our decision on whether or not we have decided to commence a review, and where applicable, the scope of that review.
- 4.7 In making a decision on whether to commence a review, in the specific case of the broadband USO, we will look to see whether sufficient network has been built and if enough premises are receiving connections to ensure that adequate information on the following is available:
- a) the infrastructure necessary to deliver the broadband USO connections requested;
 - b) the capital expenditure incurred in making these connections; and
 - c) the products purchased by the premises that are receiving these connections.
- 4.8 At this stage, we think that this information is unlikely to be available until at least one year after the universal service conditions requiring the provision of broadband USO connections have come into force.⁶⁴

Proposed frequency of commencing a review of a net cost

- 4.9 We consider it is proportionate to review no more than one net cost claim relating to the same universal service conditions per year. We consider this frequency strikes an appropriate balance between ensuring on the one hand that the Universal Service Provider is compensated for any unfair net cost burden in a timely manner and, on the other, that the work involved in assessing the application, and where relevant collecting and distributing funds, is proportionate.
- 4.10 As such, we expect that once a Universal Service Provider has made a request relating to particular universal service conditions, irrespective of whether Ofcom chooses to commence that review or not by taking account of the considerations we have set out above, it would be appropriate for the Universal Service Provider to wait for a period of one year before making a subsequent request.

⁶⁴ These conditions come into force on 20 March 2020.

Proposed procedures for the Universal Service Provider when submitting a review of a net cost

- 4.11 The information and data submitted with a request for a review of a net cost of complying with the universal service conditions will form a key part of Ofcom's decisions. Ofcom and potential industry fund contributors need to be confident that the information submitted with the request is complete, has been prepared robustly and subject to appropriate checks and verification procedures. To provide this confidence, we consider it is important that a director within the Universal Service Provider's organisation should be accountable for the information submitted alongside a request to commence a review. We therefore propose by way of guidance that any request to commence a review of a net cost:
- a) contain a statement explaining the following in relation to the information submitted:
 - i) the information is accurate, fair and complete in explaining the methodology adopted and verification steps taken when calculating a net cost; and
 - ii) all reasonable steps have been taken to ensure that any estimates of a net cost and information serving as the basis of any calculations represent an accurate, fair and complete view; and
 - b) be signed by a director.⁶⁵

Making an application requesting compensation for any unfair burden

- 4.12 The Act specifies that Ofcom can only determine that an industry fund should be set up if the Universal Service Provider has made a specific application requesting that Ofcom determine that other communications providers make contributions towards meeting that burden.⁶⁶
- 4.13 Where Ofcom chooses to commence a review of the net cost of complying with particular universal service conditions, and notifies the Universal Service Provider of that decision, the draft funding regulations allow for the Universal Service Provider to submit an application for industry contributions no later than two months after the opening of the review.⁶⁷ We expect the Universal Service Provider is likely to make this application as soon as it can after it receives notification that Ofcom is commencing a review.

⁶⁵ We use the term 'director' within the meaning of section 250 of the Companies Act 2006, namely a person who is appointed as director, subject to the duties specified in the legislation and notified to the Companies House as director. It will be for the Universal Service Provider to decide which of its directors should sign off on the net cost claim and supporting evidence to be submitted to Ofcom. We would expect that in practice it is likely to be most appropriate for the Universal Service Provider's Finance Director (or equivalent) to be responsible for that.

⁶⁶ Section 71(3) of the Act.

⁶⁷ Draft funding regulation 8.

Proposed procedures for the Universal Service Provider when submitting an application for compensation from an industry fund

4.14 A potential consequence flowing from the application for an industry fund is that contributions in respect of any unfair net cost burden which Ofcom finds to exist could be required from industry. Ofcom and potential contributors to an industry fund need to be satisfied that the Universal Service Provider has properly considered whether to seek such contributions. Therefore, the draft funding regulations specify that any application must be made in writing and signed by a director.⁶⁸

Determinations Ofcom may make when assessing a net cost claim

- 4.15 Once Ofcom has decided to commence a review of a potential net cost, we may need to make the following determinations as part of the funding process.
- a) Having opened a review, we will need to determine the **existence** and, if required, the **level of any net cost** incurred by the Universal Service Provider. We set out the approach we will take in Section 5.
 - b) Having determined the existence and level of a net cost, we will need to determine whether it would be **unfair** for the Universal Service Provider to bear some or all of this net cost. We explain how we will approach this in Section 6.
 - c) Having determined the existence of an unfair net cost, and where the Universal Service Provider has made an application to be compensated for any unfair burden through an industry fund, we will need to determine whether there should be a **sharing mechanism** that will compensate the Universal Service Provider and, if so, the nature of that sharing mechanism. We explain how we will approach this in Sections 7 and 8.
- 4.16 For each of these determinations, Ofcom will engage with stakeholders by consulting on a draft determination and take account of representations made over the consultation period when making a final determination. The consultation period will, as a minimum, be no less than one month from the day after the draft determination is published.⁶⁹ The draft funding regulations enable these determinations to be made simultaneously should we decide this is appropriate. This would ensure that the process of compensating a net cost, if any, takes place in a timely way.⁷⁰

Finality

4.17 In fulfilling our role, we will aim to provide certainty to Universal Service Providers on the costs, if any, that it will be compensated for, and certainty for industry fund contributors on the level of contributions which they will be required to make. Given this objective to provide certainty to both parties, we do not consider that it would be appropriate to re-

⁶⁸ Draft funding regulation 8(2)(c).

⁶⁹ Draft funding regulations 7 and 13.

⁷⁰ Draft funding regulation 15.

assess a net cost relating to any specific USO connections that have already been covered by an existing determination.

- 4.18 In practice, if having determined that an industry fund should be set up, we will seek to collect contributions and compensate the Universal Service Provider for this burden as swiftly as possible. Once any payment to a Universal Service Provider has been made, the legislation does not provide for a mechanism to recoup monies should any assessment be later found to result in a smaller unfair financial burden.⁷¹
- 4.19 If an assessment was later found to result in a larger unfair financial burden, there would be a further administrative burden on Ofcom associated with collecting and distributing any residual amount of money; and on industry fund contributors who may have relied on the original determination to plan and budget for any fund contributions.
- 4.20 The practical difficulties in re-assessing a claim for which a determination has been made necessarily means we have to consider the likelihood of information becoming available in the future which may have a bearing on our assessment before we decide whether we should commence a review, and what the scope of a review should be. Once we have decided to commence a review, we expect the information and assurances provided as part of the request to ensure that we have an appropriate basis upon which to make an accurate assessment. Therefore, we expect that only in exceptional circumstances would we commence a review that materially covers the scope of one or more previous reviews.
- 4.21 Circumstances are only likely to be deemed exceptional if we consider they were unforeseen and of such scale as to be outside of normal commercial risks (as explained in Section 5). Should exceptional circumstances materialise and should we decide to review a net cost that was materially covered by an existing determination, we envisage informing any parties that may be affected by this as soon as reasonably practicable. As part of that, we would explain the change of circumstances and why we considered it to be exceptional.

Summary of draft funding regulations

- 4.22 In summary, the draft funding regulations on the procedures for a review of a net cost and on the submission of an application for compensation in respect of any unfair net cost are as follows:
- a) Ofcom will consult on its proposals before making a determination on a net cost of compliance; whether it would be unfair for the Universal Service Provider to bear all or part of that net cost; and, where applicable, who should contribute to any industry fund and in what proportion;
 - b) the Universal Service Provider will have a period of two months to make an application for compensation which will commence on the date that Ofcom opens a review of any net cost of compliance; and

⁷¹ Any attempt to recoup this money may be possible and pursued under general law.

- c) any application for compensation must be made in writing to Ofcom and be signed by a director of the Universal Service Provider.

Summary of our guidance

4.23 We also provide guidance on our approach on the procedures for a review of a net cost to include:

- a) that a period of one year should elapse between each request to review a net cost which relates to the same universal service conditions;
- b) any request to review a net cost must be made in writing to Ofcom with a signed statement by a director to confirm the information provided is accurate, fair and complete;
- c) Ofcom will decide whether to commence the review, and what the scope of any review should be before notifying the Universal Service Provider of its decision; and
- d) Ofcom will not re-assess the scope of any net cost that is materially covered by an existing determination except in exceptional circumstances.

Question 1: Do you agree with our proposed procedures for commencing a review of a net cost of complying with universal service conditions?

Question 2: Do you agree with our proposed procedures for making an application requesting compensation for any unfair burden?

Question 3: Do you agree with our proposed procedures when making determinations when assessing a net cost claim, including our proposed approach to finality?

5. Calculating and verifying a net cost

- 5.1 In this section, we first summarise the principles set out in the Universal Service Directive that relate to the calculation of any net cost of complying with universal service conditions. We then explain the proposed process to assess an application to review any net cost claim, including that:
- a) we will need sufficient information to make the assessment as to whether any net cost represents an unfair burden on the Universal Service Provider (see Section 6). As much of this information will be held by the Universal Service Provider, we are proposing to specify in the funding regulations information that the Universal Service Provider will be required to submit. Ofcom will then make an assessment as to whether it has sufficient information to open a review;
 - b) we will need to calculate and verify any net cost. The nature of this exercise will depend on the scale, scope and nature of the request being submitted. We do not propose to specify in the funding regulations a detailed approach to calculating and verifying a net cost but we do propose to set out the matters which Ofcom considers appropriate when calculating a net cost. We also provide guidance on how we will approach this exercise in practice. In addition, we provide further guidance on this in Section 9 that is specific to the broadband USO, alongside our proposal to impose regulatory financial reporting directions for BT and KCOM; and
 - c) Ofcom will need to audit its net cost calculation in line with the Universal Service Directive and the Act. We expect that this will involve an audit of the financial model used by Ofcom for the purpose of making a determination on a net cost.

Principles for the calculation

- 5.2 As set out in Section 3, the Universal Service Directive and the Act contain principles for the calculation of a net cost. The Act states that the financial burden of complying with one or more universal service conditions *“is to be taken to be the amount calculated by OFCOM to be the net cost of compliance after allowing for market benefits accruing to the designated universal service provider from—(a) his designation; and (b) the application to him of universal service conditions.”*⁷²
- 5.3 The Universal Service Directive explains that a net cost is to be calculated:
- a) as the difference between operating with the USO and operating without the USO;
 - b) taking due account of costs and revenues, as well as the intangible benefits from providing the USO;
 - c) the calculation needs to ensure that any costs that the Universal Service Provider would have chosen to avoid had there been no USO are taken account of;

⁷² Section 70 of the Act.

- d) it should include an estimate of the indirect benefits that the Universal Service Provider derives from being designated;
 - e) a net cost calculation should be based upon the costs attributed to elements of the services provided at a loss or not commercially;⁷³ and
 - f) a net cost calculation should also avoid double counting of any costs and benefits and should be performed on the basis of transparent procedures.
- 5.4 The Universal Service Directive also sets out that we are to consider all means to ensure appropriate incentives for undertakings (designated or not) to provide universal services cost efficiently.⁷⁴
- 5.5 After carrying out calculations of a net cost, we must either obtain an audit of those calculations by a person who appears to us independent of the Universal Service Provider; or audit those calculations ourselves.⁷⁵

Process of assessing a request for review of a net cost

Information to be provided with any net cost claim

- 5.6 As we explain in Section 4, when requesting a review of a net cost of complying with the particular universal service conditions, the Universal Service Provider should ensure that the request contains the required information. The nature and detail of information supplied alongside a request will be dependent on the nature and scale of the USO.
- 5.7 It is for the Universal Service Provider to ensure that it provides us with information to enable us to determine the existence of a net cost, and we are proposing to set requirements for the provision of information within the draft funding regulations. These cover information to enable us to determine the existence, and if required, the level of a net cost. Ofcom will then make an assessment as to whether it has sufficient information to open a review. The draft funding regulations therefore specify that the Universal Service Provider must provide:
- a) its own estimate of the net cost of complying with the conditions;
 - b) the calculation used to arrive at that estimate;
 - c) an explanation of the methodology it has used when performing that calculation;
 - d) the accounts or other information which serve as the basis for the calculation of the net cost;
 - e) an explanation of the steps taken to verify the information on which the calculation is based;

⁷³ Including losses as a result of serving particular end-users or through geographical averaging of prices.

⁷⁴ Part A of Annex VI of the Universal Service Directive.

⁷⁵ Section 70(4) of the Act.

- f) the evidence that the net cost was efficiently and necessarily incurred;
- g) any other information identified as appropriate by Ofcom having regard to the facts and circumstances of the case;⁷⁶ and
- h) an explanation of why the Universal Service Provider considers the identified net cost to be an unfair financial burden alongside any supporting information to justify its explanation.⁷⁷

5.8 It is the efficient net cost of providing the USO which will be the focus of any net cost assessment. In that respect, we consider that efficiency includes (among other things) considering whether the Universal Service Provider has used the most efficient technology to deliver USO connections and incurred an efficient level of costs in delivering USO connections.

5.9 As set out above, the Universal Service Provider will therefore need to submit information to explain how it ensured efficiency, including why it considers its choice of technology and its approach to providing connections to be efficient. Depending on the nature and size of the USO we may obtain further information as to how the Universal Service Provider has justified its technology choice and investigate what procedures and controls the Universal Service Provider has used to minimise costs.⁷⁸

Calculating, verifying and auditing a net cost

5.10 The approach to performing a net cost calculation needs to be done on a case-by-case basis and should aim to balance the need for accuracy and precision with the need to ensure that the task does not impose a disproportionate administrative burden on Ofcom and the industry. In light of that, we do not propose to specify in the funding regulations a detailed approach to calculating and verifying a net cost as our approach will depend on the nature of the claim. However, we have proposed to set out in the funding regulations the matters that Ofcom should have regard to in calculating a net cost of compliance which are derived from the principles established in the Universal Service Directive as outlined above. We therefore propose to provide that in calculating a net cost, Ofcom should have regard to the following matters as appear to us appropriate given the facts and circumstances of a particular case:

- a) the costs incurred and any costs avoided in complying with the relevant universal service conditions;
- b) the extent to which the costs of complying with the relevant universal service conditions were efficiently and necessarily incurred;

⁷⁶ Draft funding regulations 3(3) and 4.

⁷⁷ Draft funding regulation 5(3) and 6.

⁷⁸ In the context of the broadband USO, we explained in the June 2019 statement that we would expect the Universal Service Providers to supply, as part of our assessment of any unfair net cost claim, their explanation and evidence to justify claiming for any connections that exceed the reasonable cost threshold. We said that any excess costs which cannot be reasonably explained by unforeseen circumstances would not be considered efficient. See paragraph 5.101 of the June 2019 statement.

- c) the revenues and any other direct benefits generated as a result of complying with the relevant universal service conditions;
 - d) any indirect benefits that the Universal Service Provider derives from designation as a provider of a universal service and the application to that provider of the relevant universal service conditions; and
 - e) any other matters identified as appropriate by Ofcom having regard to the facts and circumstances pertaining to the case.⁷⁹
- 5.11 We also provide guidance on our approach to how we will perform the net cost calculation of delivering the broadband USO. This is set out in Section 9 alongside our proposal to impose regulatory financial reporting directions, as set out at [Annex 6](#), to require the Universal Service Providers to supply some specific information to support a request to review the net cost of compliance with the broadband USO.⁸⁰
- 5.12 Any calculation of a net cost must comply with the principles set out in the legislation as summarised in Section 3.⁸¹ A net cost to an undertaking of being designated as the Universal Service Provider will depend, amongst other things, on what would have happened if the undertaking had not been designated for the USO in question i.e. the appropriate counterfactual.
- 5.13 Considering the appropriate counterfactual allows us to identify the impact of being designated as the Universal Service Provider and complying with the associated universal service conditions. We can also distinguish those impacts from other factors that might affect the Universal Service Provider, which are not related to the USO. In Section 9, we consider the appropriate counterfactual for the broadband USO.
- 5.14 We would assess the efficient net cost of delivering the USO. To do so, we would consider the evidence that the costs were efficiently and necessarily incurred to deliver the USO in question. If we concluded that this was not the case, we would make appropriate adjustments to the net cost. This should provide an incentive for the Universal Service Provider to deliver the USO efficiently, as it risks not being compensated for any inefficiently incurred costs in delivering USO connections.
- 5.15 Factors that would influence the appropriate approach to the calculation of a net cost include the type, scale and size of any net cost. A request to review a larger net cost could justify a more detailed approach with more extensive verification processes than a request to review a smaller net cost.

⁷⁹ Draft funding regulation 3(2).

⁸⁰ This is in the form of a [template](#) appended to the proposed regulatory financial reporting directions set out in [Annex 6](#).

⁸¹ See Section 3, paragraphs 3.10 and 3.11.

- 5.16 The Universal Service Directive⁸² and the Act⁸³ set the requirements for auditing a net cost calculation and reviewing the information which served as the basis for that calculation. In order to fulfil our duties, we will carry out appropriate verification tests on costs provided by the Universal Service Provider to ensure that only costs efficiently and necessarily incurred in connection with complying with the universal service conditions are included in the net cost calculation. We will also satisfy ourselves that revenues and other benefits included in the net cost calculation are not understated.
- 5.17 In relation to our audit of a net cost calculation, we consider that an arithmetic check of our net cost calculation would be appropriate given any proposed verification processes conducted at an earlier stage, as opposed to the audit of financial statements as required under the Companies Act 2006. As the size and complexity of the calculation may vary considerably for different types of USOs, we consider that the decision on whether we should audit the calculations or obtain an audit from an independent party should be made on a case by case basis.

Summary of draft funding regulations

- 5.18 In summary, we propose to specify that in calculating a net cost, Ofcom should have regard to the following matters as appear to us appropriate given the facts and circumstances of a particular case:
- a) the costs incurred and any costs avoided in complying with the relevant universal service conditions;
 - b) the extent to which the costs of complying with the relevant universal service conditions were efficiently and necessarily incurred;
 - c) the revenues and any other direct benefits generated as a result of complying with the relevant universal service conditions;
 - d) any indirect benefits that the Universal Service Provider derives from designation as a provider of a universal service and the application to that provider of universal service conditions; and
 - e) any other matters identified as appropriate by OFCOM having regard to the facts and circumstances pertaining to the case.
- 5.19 We also propose the following draft funding regulations on the information that must be provided to Ofcom if a Universal Service Provider requests that Ofcom make a determination that there is an unfair net cost:

⁸² Article 12 of the Universal Service Directive sets out that the accounts and/or other information serving as the basis for the net cost calculation should be audited or verified by the national regulatory authority or a body independent of the relevant parties and approved by the national regulatory authority.

⁸³ Section 70(4) of the Act explains that, after carrying out calculations of the net costs of provision, Ofcom must either (i) obtain an audit of those calculations by a person who appears independent of the Universal Service Provider; or (ii) audit those calculations themselves.

- a) The Universal Service Provider's estimate of the financial burden of complying with the relevant universal service condition or conditions;
- b) calculations performed by the Universal Service Provider in order to arrive at the estimate referred to in paragraph (a);
- c) an explanation of the methodology adopted by the Universal Service Provider when performing the calculation referred to in paragraph (b);
- d) the accounts or other information serving as the basis for the calculations referred to in paragraph (b);
- e) the universal service provider's explanation of the steps taken to verify the information described in paragraph (d);
- f) the evidence that the costs of complying with the relevant universal service conditions were efficiently and necessarily incurred;
- g) any other information identified as appropriate by Ofcom having regard to the facts and circumstances pertaining to the case;⁸⁴ and
- h) contain an explanation of why the Universal Service Provider considers that it is or would be unfair for it to bear the financial burden of compliance.⁸⁵

Question 4: Do you agree with our proposal on the information the Universal Service Provider should provide alongside an application to review a net cost?

Question 5: Do you agree with our proposed approach to calculating, verifying and auditing a net cost?

⁸⁴ Draft funding regulation 3(3).

⁸⁵ Draft funding regulation 5(3).

6. Determining the extent of any unfair burden

- 6.1 If Ofcom determines that complying with the universal service conditions results in a net cost on a Universal Service Provider, Ofcom must consider whether it would be unfair for the Universal Service Provider to bear all or part of that net cost. Compensation can only be provided if we decide that there is an unfair burden. This section sets out the way in which we propose to approach whether all, or part, of a net cost is unfair.
- 6.2 We set out in Section 4 the procedures that we will follow in order to determine (among other things) the extent (if any) of an unfair net cost burden on the Universal Service Provider. In summary, we will set out our proposed decision and our reasons for making that decision in a draft determination. We will consult for a period of at least one month and having taken responses into account, we will then publish a determination.

Considerations when assessing an unfair burden

- 6.3 The relevant legislation does not provide detailed guidance on what circumstances might give rise to an unfair burden. As explained in Section 3, there is caselaw setting out that an unfair burden is a burden which, for each undertaking concerned, is excessive in view of the undertaking's ability to bear it, having taken account of the undertaking's own characteristics.
- 6.4 The caselaw also says that it falls to the national regulatory authorities (in this case Ofcom) to lay down criteria which make it possible to determine thresholds beyond which a burden may be regarded as unfair. Each individual assessment of a particular net cost must then be carried out by Ofcom against those criteria, taking account of the Universal Service Provider's relevant characteristics and circumstances prevailing at the time of the assessment. As explained in Section 3, in carrying out this role, we must have regard to our duties, including our principal duty to further the interests of citizens in relation to communications matters and the interests of consumers in relevant markets, where appropriate by promoting competition.
- 6.5 We set out below criteria that we propose should apply to considering unfairness in this context.
- 6.6 The calculation and verification of a net cost provides an important first step in the assessment of whether there is an unfair net cost burden. A verified net cost will show the existence and, if relevant, the level of the financial burden placed upon the Universal Service Provider as a result of being designated. If a net cost exists, this also demonstrates that there are elements of the identified services which can only be provided at a loss or provided under cost conditions falling outside normal commercial expectations. As explained in Section 5, it is expected that only costs efficiently and necessarily incurred in connection with complying with the universal service conditions would be included in a net cost calculation.

- 6.7 Our assessment would compare the size of any net cost with administrative burdens associated with triggering a compensation mechanism for funding the universal service as envisaged by the legislation. In particular, we would consider the cost to Ofcom and industry of establishing and administering an industry fund. We would be unlikely to consider it unfair for a Universal Service Provider to bear a net cost if the cost of setting up and administering an industry fund was disproportionate, compared to the likely amount of any prospective compensation.
- 6.8 We would also consider the impact on the Universal Service Provider of bearing any net cost, having regard to its specific characteristics and circumstances prevailing at the time. When considering the relevant characteristics at the time of our assessment, we would have regard to the characteristics referred to by the European Court of Justice, namely the quality of the Universal Service Provider's equipment, its economic and financial situation and its market share.⁸⁶ In particular, we propose that our assessment of unfairness should take into account the following factors:
- a) the degree to which the Universal Service Provider is exposed to competition (since firms with greater market power are less likely to suffer a competitive disadvantage or other adverse effects from bearing a net cost); and
 - b) the extent to which the Universal Service Provider is constrained by regulation in the market in question or a closely related market (which could limit the ability of a firm with market power to set prices and so will limit its ability to bear a net cost).
- 6.9 We consider that the method of designation is also relevant to the question of whether a verified net cost might constitute an unfair burden. Where a provider is directly designated and has relatively limited control over the universal service conditions it faces, we are more likely to find the associated burden unfair, other things being equal.
- 6.10 As set out in Section 4, there may be several determinations on the net cost of complying with a particular set of universal service conditions. In making each unfairness determination we will consider whether there are any further criteria which may be relevant in addition to those outlined above. Where relevant, we will also take into account the outcome of any previous determinations of the net costs of complying with the same universal service obligations which the Universal Service Provider has borne up to that point (i.e. because it was not previously deemed unfair for the Universal Service Provider to bear those costs).
- 6.11 We have reflected the above criteria in the draft funding regulations. In making our determination on unfairness, we will also consider the explanation provided by the Universal Service Provider⁸⁷ as to why it considers that compliance with the relevant set of universal service conditions represents an unfair burden for it.⁸⁸

⁸⁶ Paragraph 49 of the judgments in case C-222/08.

⁸⁷ As explained in Section 5, we have proposed to include a provision in the draft funding regulations requiring the Universal Service Provider to submit such an explanation to Ofcom. See draft funding regulation 6.

⁸⁸ Draft funding regulations 5(2) and 5(3).

Summary of our proposed approach and draft funding regulations

- 6.12 The assessment of whether it is unfair for the Universal Service Provider to bear a net cost in a particular case would need to be made against the criteria outlined above and any further criteria which we may identify as relevant at the time of our assessment. The outcome of that assessment (i.e. determination by us of whether or not a particular net cost represents an unfair burden) would take into account the relevant characteristics of the Universal Service Provider in question and circumstances prevailing at that time which we would need to consider carefully in order to fulfil our duties.
- 6.13 In summary, we propose that in assessing unfairness, Ofcom must have regard to the following matters as appropriate in light of the facts and circumstances of a particular case:
- a) the extent to which the Universal Service Provider is subject to competition in relevant markets;
 - b) the extent to which the Universal Service Provider is constrained by regulation in relevant markets;
 - c) the nature of the particular procedure which has been used for the designation of the Universal Service Provider;
 - d) the likely costs associated with establishing and administering an industry fund; and
 - e) any other matters identified by Ofcom as appropriate having regard to the facts and circumstances pertaining to the case, such as the outcome of any previous unfairness determinations.
- 6.14 In making the unfairness assessment, Ofcom shall take into account the explanation provided by the Universal Service Provider as to why it considers that compliance with the relevant set of universal service conditions represents an unfair burden for it.

Question 6: Do you agree with the proposed factors we will consider when assessing an unfair burden?

7. Establishing an industry fund

- 7.1 In this section, we set out the rules and procedures for establishing an industry fund, should Ofcom find that there is an unfair net cost burden. This includes:
- a) determining whether an industry fund should be set up;
 - b) determining the contributors to an industry fund; and
 - c) determining the level of contributions to an industry fund.

Determining whether an industry fund should be set up

- 7.2 The legislation, as summarised in Section 3, provides that where Ofcom has determined that there is an unfair net cost burden, the Universal Service Provider must be compensated for that burden from public funds, an industry fund or a combination of the two. In addition, for Ofcom to be able to set up an industry fund, the Universal Service Provider must make an application for industry contributions.⁸⁹
- 7.3 These requirements mean that in carrying out our role we will have to consider both of the following:
- a) first, whether the Universal Service Provider has made an application for industry contributions in accordance with the relevant provisions of the funding regulations; and
 - b) second, whether public funding is committed to covering the whole or part of an unfair net cost burden.
- 7.4 We have reflected those requirements in the draft funding regulations which provide that where Ofcom has determined that there is an unfair net cost burden and the Universal Service Provider has made an application for industry contributions:
- a) an industry fund will be set up compensating the Universal Service Provider for an unfair net cost in full where there are no public funds committed to compensating the Universal Service Provider;
 - b) conversely, if the Universal Service Provider will be compensated in full from public funds, no industry fund will be established by Ofcom; and
 - c) if public funds are committed to compensate the Universal Service Provider for only part of an unfair net cost, then an industry fund will be set up to pay the remainder.⁹⁰
- 7.5 The draft funding regulations do not permit Ofcom to set up an industry fund if public funds have been committed to compensating the Universal Service Provider for the full

⁸⁹ Section 71(3)(b) of the Act. When we refer to ‘an application for industry contributions’ in this consultation, we mean an application for a determination that contributions are to be made by communications providers to whom general conditions are applicable for meeting the amount of financial burden of complying with universal service conditions which Ofcom has determined it would be unfair for the Universal Service Provider to bear under section 70(3) of the Act.

⁹⁰ Draft funding regulation 9.

amount of an unfair net cost burden. This is the case regardless of whether the Universal Service Provider has made an application for industry contributions. The draft funding regulations provide that where it appears to Ofcom that public funds may be used, the calculation of any amount to be collected from an industry fund will be postponed.

- 7.6 We also propose a provision which would allow the Universal Service Provider to waive its right to all or part of the compensation, should it choose to do so. This right would be exercisable at any time, including once the Universal Service Provider has asked Ofcom to set up an industry fund.

Contributors to an industry fund

- 7.7 The purpose of an industry fund is to compensate the Universal Service Provider for the unfair net cost burden Ofcom determines by sharing that burden with the wider industry. Under the legislation, our objective is to design a sharing mechanism that is transparent, proportionate, non-discriminatory and which results in the minimum distortion to competition and to user demand. The mechanism must also be workable in practice.
- 7.8 The legislation allows for costs to be recovered from providers of ECN and/or ECS within the UK, or from a subset of those providers. If we consider this to be appropriate, we have the power to require only particular providers or a particular description of providers to contribute, including requiring contributions only from undertakings whose national turnover is more than a set limit.⁹¹

Providers that should contribute to an industry fund

- 7.9 ECN and/or ECS providers incorporate a wide range of suppliers offering access to sets of different products. They include fixed providers, mobile providers, and suppliers of a wide range of other communications networks and services.
- 7.10 We note that the definition of ECS has been revised in the Code, bringing certain 'over the top' services into scope of the revised definition. These services are referred to in the Code as Number-Independent Interpersonal Communications Services ("NIICS"). As noted in Section 3, the Government indicated in July 2019 that its intention was to implement the Code in full into the UK's law by 21 December 2020. If the UK's legislation is amended to reflect that, suppliers of NIICS will, in the same way as all other ECS, fall within the description of providers Ofcom may require to contribute to an industry fund for a USO. Depending on when a request for compensation may be made, and assuming an unfair net cost burden is found, we will determine appropriate providers or an appropriate description of providers in light of the definition of ECS that is in force at the time.
- 7.11 We consider each of the relevant four principles (transparency, no undue discrimination, proportionality and least market distortion) in the context of how we will decide which ECN and/or ECS providers should be required to contribute to an industry fund. In doing so,

⁹¹ Article 13 of the Universal Service Directive.

we explain how these principles affect both the rules and procedures proposed in the draft funding regulations and the framework for making subsequent decisions under those regulations in respect of a particular net cost claim.

Transparency

- 7.12 Transparency encompasses a number of features which focus on ensuring that sufficient information relating to the sharing mechanism is provided, including our justification for the chosen approach and the evaluation of competing considerations.
- 7.13 Transparency will also require us to ensure that a sharing mechanism is easily understandable. This may point us against adopting a particular approach which could result in a complex system of deciding which providers should be included or excluded from an obligation to contribute.

No undue discrimination

- 7.14 When determining who should contribute to an industry fund, we need to be mindful of the need to avoid undue discrimination towards a contributor or a description of contributors.
- 7.15 This will require us to consider whether potential contributors, or potential descriptions of contributors, are similarly situated. When assessing whether potential contributors are similarly situated, it may be necessary for us to consider whether and, if so, the extent to which they are in competition with one another. We discuss this in more detail under the least market distortion heading.
- 7.16 However, there may be other relevant dimensions which we may need to consider when deciding which providers should contribute to an industry fund. For example, we note that the purpose of the USO framework is to secure that all consumers have access to the minimum set of communications services to ensure their full social and economic participation in society. Such interventions are therefore likely to bring benefits to the wider economy and to society as a whole. However, there may be particular types of USO interventions which could stand to deliver additional benefits to certain providers, certain descriptions of providers, or their customers. In such cases, it may be appropriate to consider whether the type and/or scale of those benefits may mean that those providers, or those descriptions of providers, are differently situated to other providers.
- 7.17 If we find, having identified the relevant factors to consider, that certain contributors or certain descriptions of contributors are similarly situated, we will need to ensure that they are given equality of treatment unless there are circumstances which objectively justify a difference in treatment. Equally, if potential contributors or potential descriptions of contributors are not similarly situated, we will need to take account of those differences when making our decisions.
- 7.18 These considerations will vary depending on the specifics of the USO intervention, the benefits that the USO delivers and on the market context. This part of the analysis therefore needs to be carried out on a case-by-case basis.

Proportionality

- 7.19 Proportionality requires that the means used to achieve a given end must be no more than that which is appropriate and necessary to achieve that end. This means that our chosen approach should be fully justified and involve a consideration of possible alternatives.
- 7.20 In considering the proportionality of our decisions in a particular case, it will be important for us to explain what our objectives are in setting up an industry fund so that the proportionality of our proposals can be assessed against those objectives. In identifying relevant objectives in a particular case, we will always have regard to the overarching purpose of the universal service obligations which is to act as a safety net for the benefit of consumers, in order to prevent social and economic disadvantage. When establishing an industry fund, our starting point is that we will always seek to create a practical and fair system for meeting an unfair net cost burden, taking into account the administrative burden of establishing and operating an industry fund for Ofcom and the industry. There may be additional considerations which affect our overall objective in particular cases.

Least market distortion

- 7.21 As a sharing mechanism involves financial transfers between contributors and the Universal Service Provider, it has the potential to distort competition and user demand. The provisions of the Universal Service Directive require us to seek to minimise those distortions as far as possible.⁹²

Avoiding distortion of competition

- 7.22 If the USO results in an unfair net cost burden, this means that the direct and indirect benefits to the Universal Service Provider are not sufficient to cover the costs of providing the USO. This shortfall would, if left uncompensated, potentially risk putting the Universal Service Provider at a competitive disadvantage, whilst offering an advantage to the Universal Service Provider's competitors. It is therefore an important function of any industry fund to share an unfair burden of the USO with the Universal Service Provider's competitors.
- 7.23 In addition, when deciding on the set of contributors, it may be appropriate and relevant to consider whether, and if so the extent to which, an industry fund may create a competitive distortion. For example, this could be the case if one or more of the contributors to an industry fund is in competition with a provider that does not contribute to the fund. Such risks of competitive distortion will depend in any particular case on the size of an unfair net cost burden, the pool of contributors (and any non-contributors) and the extent of competition between them. All other things being equal, the risks of competitive distortion are likely to be more significant where the net cost is a larger sum, since the burden on individual contributors would be greater. Assuming the same level of

⁹² See Part B of Annex IV of the Universal Service Directive which says: "Because such a compensation involves financial transfers, Member States are to ensure that these are undertaken in an objective, transparent, non-discriminatory and proportionate manner. This means that the transfers result in the least distortion to competition and to user demand."

unfair net cost burden, the risks are likely to diminish where the pool of contributors is wider, since each individual contributor would bear a smaller share of the overall net cost burden. Again, for a given level of unfair net cost burden, the risks of a competitive distortion will also diminish when the pool of contributors faces more limited competition from non-contributors.

- 7.24 The extent to which the USO and an industry fund may create competitive distortions depends in large on the size, scope and design of the USO and on the size of any unfair net cost burden that results. It will also depend on the extent and nature of competition between the Universal Service Provider and other firms over the expected duration of an industry fund, recognising that competition between firms can occur in a variety of different ways and can change over time. This part of the analysis therefore needs to be conducted on a case-by-case basis for each prospective industry fund.

Avoiding distortion of user demand

- 7.25 The legislation provides that the least market distortion principle means that contributions should be recovered in a way that, as far as possible, minimises the impact of the financial burden falling on end-users, for example by spreading contributions as widely as possible.
- 7.26 It is possible that the requirement to make contributions may cause contributors to increase their prices.⁹³ Price increases may cause a distortion in user demand if consumers purchase smaller amounts of the products subject to a price rise. This may in turn cause consumers to consume a less optimal mix of products and/or to purchase fewer goods and services overall, both of which would reduce economic efficiency and consumer welfare. The scale of this distortion would depend on the size of any price increase and how sensitive consumers' decisions are to changes in price. The risk of a price impact and of the associated distortion in user demand will be greater, all other things being equal, where the amount of funding to be collected by an industry fund is larger.
- 7.27 In principle, the risk of these distortions may be reduced if we choose a wider set of contributors. A wider set of contributors increases the number of providers affected, but each provider bears a smaller burden, leading to a smaller potential for distortion in the prices of their services.
- 7.28 The above factors may therefore point towards a wider pool of contributors providing a wider set of services to spread the burden of an unfair net cost although the extent to which there is a risk of a distortion in user demand will vary from case to case depending on the size of the industry fund.

Turnover threshold

- 7.29 We will also need to weigh up and balance the four principles when deciding what an appropriate turnover threshold would be in a particular case. Some of the considerations set out above will also be relevant to our choice of turnover threshold. In practice, we will

⁹³ Whether they do so in practice is difficult to predict and will depend on the specifics of the sharing mechanism and the markets in which contributors operate.

choose the combination of provider description and turnover threshold that we consider best reflects the four principles outlined above.

- 7.30 For example, requiring contributions from small firms, that have not yet achieved a significant market presence, has the potential to inhibit entry into markets and this can distort competition in the longer term. This distortion can be avoided by exempting such providers. To determine the appropriate threshold we will need to balance the effect of the threshold on competition in the longer term with the impact that excluding smaller competitors has on the remaining contributors.⁹⁴
- 7.31 In addition, it would be relevant to take into account proportionality when setting the turnover threshold. A threshold at a low level will share the burden of the USO more widely, reducing the burden on each individual contributor. However, this may also lead to a large number of contributors making small financial contributions to an industry fund. The burden associated with obtaining these small financial contributions might not be proportionate to the benefit achieved by reducing contributions from other providers.
- 7.32 Where we decide that setting a particular turnover threshold is appropriate, we will always need to consider whether imposing such a threshold may lead to similar providers being treated differently and, if so, whether there is a sufficiently strong justification for the different treatment.
- 7.33 These judgements will depend on the specific characteristics of the USO and the relevant facts that apply at the time we make this decision. We do not therefore think that it would be appropriate to specify a particular threshold in the funding regulations and will determine the threshold on a case-by-case basis.⁹⁵

Summary of our proposed approach

- 7.34 There is no hierarchy between the four principles of transparency, no undue discrimination, proportionality and least market distortion. In some cases, they might point in different directions or have overlapping considerations. When making decisions we must therefore look at all of the principles and how they interrelate, giving such weight as we consider appropriate to each of the relevant factors. Determining the weight that should be given to each principle will therefore need to be carried out on a case-by-case basis, taking into consideration the relevant factors as they apply at the time and given the specific characteristics of the USO.
- 7.35 In light of this, we do not think that it would be appropriate for us to specify a particular set of contributors in the funding regulations. However, we do specify that our decisions concerning the assessment of contributions should be made having regard to the principles of transparency, least market distortion, no undue discrimination and proportionality.⁹⁶

⁹⁴ As noted above, exempting some providers that are in competition with each other can also lead to a competitive distortion.

⁹⁵ Draft funding regulation 11(b).

⁹⁶ Draft funding regulation 14. This requirement is also proposed to apply to decisions concerning the collection and distribution of contributions.

- 7.36 There are also a number of ways in which we are seeking to ensure that our approach to making the funding regulations, as well as subsequent decisions under those regulations, is appropriate in light of the principles specified in the legislation.
- a) First, we are consulting on the proposed rules and procedures for deciding which providers should contribute and will ensure that our decisions on what rules and procedures should be included in the final funding regulations reflect stakeholders' comments as appropriate.
 - b) Second, in each particular case we propose to set out the contributors to any industry fund and our reasons why we believe that those entities should be contributors in our draft determination. As set out in Section 4, we will consult on that determination and take stakeholder responses into account before issuing our determination.
- 7.37 We consider that this approach allows us to select contributors in a way which we consider reflects the principles specified in the legislation and any comments from providers who are likely to be affected by a determination under the funding regulations.

Calculation of contributions

- 7.38 The legislation requires that contributions are collected in a transparent and neutral way which avoids the danger of double imposition of contributions falling on both the outputs and the inputs of undertakings.⁹⁷
- 7.39 In considering what an appropriate approach to calculating contributions should be, we recognise that Ofcom uses relevant turnover⁹⁸ as the basis of calculating contributions to its administrative costs ("administrative levy"). This represents the turnover generated by undertakings when providing networks and services in the UK, which includes both revenue from the wholesale supply of such services and the retail supply of those services to end-users. If we were to follow the same approach to calculate contributions in the context of the USO, this relevant turnover approach would impose contributions both on the inputs and the outputs of undertakings that purchase networks and services from other providers in the UK. We do not therefore consider that it would be appropriate to use this as the basis for calculating contributions for a sharing mechanism for a USO in light of the requirements contained in the legislation.⁹⁹
- 7.40 We consider that using net relevant turnover would be a more appropriate approach. As we explain in Annex 7, net turnover allows undertakings to deduct payments from their relevant turnover where those payments will form the basis of a contribution to an industry fund by another contributor. This avoids the possibility of contributions falling on both the outputs and the inputs of an undertaking because the turnover associated with those inputs is deducted.

⁹⁷ Annex IV of the Universal Service Directive.

⁹⁸ Ofcom, February 2005. [Statement of Charging Principles](#), page 9.

⁹⁹ As set out in Section 3, the legislation requires that contributions are collected in a transparent and neutral way which avoids the risk of the double imposition of contributions falling on both outputs and inputs of undertakings.

- 7.41 Net relevant turnover is based on relevant turnover, which we already collect and verify as part of our administrative levy. This approach therefore has practical benefits both for Ofcom and for contributors. We therefore propose to use net relevant turnover as the basis for the calculation of the payments.
- 7.42 The share of an unfair net cost paid by a particular contributor would therefore correspond to that undertaking's net relevant turnover as a proportion of the net relevant turnover of all industry fund contributors. The draft funding regulations provide for a possibility of more than one description of contributors. Where this is the case, we may also take account of any specific characteristics of a particular description of contributors in determining the proportion that contributors should pay to an industry fund.¹⁰⁰

Summary of draft funding regulations

- 7.43 In summary, the draft funding regulations set out the following procedures for establishing an industry fund:
- a) Ofcom will establish an industry fund to compensate the Universal Service Provider if the following conditions are satisfied:
 - i) Ofcom determines that there is an unfair net cost burden;
 - ii) the Universal Service Provider makes an application for industry contributions;
 - iii) the Universal Service Provider has not waived its right to all or part of the compensation; and
 - iv) if the unfair net cost burden will not be financed by public funds.
 - b) Ofcom will determine particular communications providers, or a particular description of them, who will contribute to an industry fund and can require contributions only from undertakings whose turnover is more than the limit we specify in our determination. In making those determinations, Ofcom must have regard to the principles of transparency, least market distortion, no undue discrimination and proportionality.
 - c) Ofcom will publish its proposals and will specify the period within which representations about Ofcom's proposals may be made by those likely to be interested or affected by it. Any such period must be not shorter than one month.
 - d) Once Ofcom considers these representations, it will publish its determination setting out the total amount to be compensated, identifying contributors to an industry fund and the proportions in which particular contributors, or particular descriptions of them, will be required to contribute.

¹⁰⁰ See draft funding regulation 12.2.

Question 7: Do you agree with our proposed approach to determining whether an industry fund should be set up?

Question 8: Do you agree with our proposed approach to determining which providers will contribute to any industry fund?

Question 9: Do you agree with our proposed approach on calculating contributions from fund contributors?

8. Procedures for the collection and distribution of funds

- 8.1 In this section we set out our proposals for the process by which we would collect funds from industry and compensate the Universal Service Provider, if we find that there is an unfair net cost burden and have determined that there should be an industry fund.
- 8.2 The draft funding regulations set out the proposed way in which Ofcom would collect contributions from those communications providers it determines should contribute to an industry fund and when those contributions would be distributed to the Universal Service Provider. The draft funding regulations also set out the steps that Ofcom may take in the event that contributors fail to make payment of the sums due to an industry fund.

Collecting contributions to an industry fund

Collecting and verifying turnover data

- 8.3 The draft funding regulations specify that a contributor to an industry fund would pay a portion of an unfair net cost. Their individual contribution would be related to their net relevant turnover.¹⁰¹ Net relevant turnover is the turnover that an undertaking generates from ECN and ECS within the UK, less any payments it makes to other undertakings for such services.¹⁰² As we do not currently collect net relevant turnover information from providers, we would need to collect this information to enable us to calculate providers' respective contributions.
- 8.4 Given that calculating net relevant turnover would impose an administrative burden on providers, we consider that it would be disproportionate to collect this information routinely, for example annually alongside relevant turnover information collected for calculating the administrative levy. We therefore propose to collect this only where we are assessing an application for compensation, at the point we require the information.
- 8.5 To help providers ensure that they submit the correct information, we plan to issue guidance setting out a definition of net relevant turnover. Our draft guidance can be found in Annex 7. As we currently collect relevant turnover information for the administrative levy based on the calendar year, we plan to take the same approach for net relevant turnover to minimise the administrative burden on providers.
- 8.6 As the net relevant turnover figures we collect from providers would inform our calculation of individual contributions, we propose to take steps to verify this information and ensure its accuracy.

¹⁰¹ Our reasoning for this is explained in Section 7.

¹⁰² See Annex 7.

- 8.7 We plan to use relevant turnover information that we collect annually for the administrative levy as the basis for verifying net relevant turnover information. In respect of the administrative levy, we currently verify the relevant turnover information for certain communications providers each year, which involves the following checks:
- a) Requesting an extract from providers' internal records showing a reconciliation between the turnover reported in its statutory accounts and relevant turnover submitted to Ofcom.
 - b) Ensuring the income streams excluded as non-relevant are appropriate and in line with the *Statement of Charging Principles*.¹⁰³
 - c) Asking providers to explain any material movement in their year-on-year relevant and non-relevant turnover.
- 8.8 We may carry out additional verification work on the net relevant turnover information as we find necessary and proportionate, considering the size of an unfair net cost burden. This may mean collecting additional information from providers and we would seek this as required.
- 8.9 Once we have established the group of contributors, we propose to calculate industry fund contributions with reference to the verified net relevant turnover information. Any errors in the net relevant turnover information submitted by providers could result in the need to re-calculate invoices, which would be complicated and introduces uncertainty for industry fund contributors. It is therefore important that providers supply us with the correct information in the first instance. We would collect net relevant turnover information using our powers under section 135 of the Act, which gives us the right to take appropriate enforcement action against any provider who submits incorrect information.

Invoicing contributors

- 8.10 The draft funding regulations specify that Ofcom would send an invoice to each entity required to contribute to an industry fund apart from the Universal Service Provider.¹⁰⁴ Where the Universal Service Provider is required to share a proportion of an unfair net cost burden, we would deduct the Universal Service Provider's contribution from an unfair net cost and then invoice the other contributors to recover the residual amount.
- 8.11 The invoice would explain when and how the sums due should be paid by a contributor. The draft funding regulations state that a contributor must pay the contribution in the manner specified in the invoice and by the deadline set out in the invoice.¹⁰⁵ We would issue invoices after publication of our determination and give sufficient notice to contributors on the specific amount they would be required to pay. Payment must be made within the time period specified in the invoice.

¹⁰³ Ofcom, February 2005. [Statement of Charging Principles](#).

¹⁰⁴ Draft funding regulation 16(1).

¹⁰⁵ Draft funding regulation 16(2).

- 8.12 The draft funding regulations also provide that in setting out the proportion of an unfair net cost to be paid by a particular contributor in a determination, Ofcom should specify:
- a) on what date payment to the Universal Service Provider is envisaged to take place (“the relevant date”);¹⁰⁶ and
 - b) the percentage by which that amount of an unfair net cost will increase after the relevant date; for example, if an instalment plan is offered by Ofcom and elected by a contributor, or where payment is late (i.e. payment is made after the relevant date which is set out in an invoice).¹⁰⁷
- 8.13 A determination on the level of an unfair net cost would involve a decision on the relevant period covered, which takes into account the date on which compensation is paid. To ensure the Universal Service Provider is not disadvantaged for any significant period between that determination and the payment from the fund, we anticipate specifying the percentage by which the amount of an unfair net cost would increase if there was any delay in payment beyond the date on which it was envisaged that payment would be made. We would set out that percentage in each case in our determination.
- 8.14 The draft funding regulations also provide that Ofcom may permit a contributor to pay the invoice in instalments.¹⁰⁸ We may allow for payment by instalments where this is appropriate in light of the amount charged and in line with the principle of proportionality. In such case, the overall amount of an unfair burden payable by that contributor would also increase if it chooses this payment method.
- 8.15 To ensure no undue discrimination between providers, this option would be available to all contributors where the amount due is over a specified level. We would set out whether payment by instalment would be an option, and the relevant terms, in our determination. Where we make this option available, contributors can either pay as a lump sum or choose to pay by instalments.

Process by which we would compensate the Universal Service Provider

- 8.16 Where we are in receipt of industry fund contributions, we propose to transfer these contributions to the Universal Service Provider once per month, unless, in our opinion, it would be inappropriate to do so.¹⁰⁹ The amount paid would comprise of all the industry fund contributions we have received in the previous month and any additional amounts due and collected in respect of payment of contributions after the relevant date as specified by Ofcom. This approach would ensure that a Universal Service Provider is compensated in a timely manner and avoids unnecessary delay while permitting us to

¹⁰⁶ The relevant date is described in the draft funding regulation as the assumed date.

¹⁰⁷ Draft funding regulation 13(6).

¹⁰⁸ Draft funding regulation 16(3).

¹⁰⁹ Draft funding regulation 17.

adopt a different approach if the default option would, in particular circumstances, be inappropriate.

- 8.17 Under the Universal Service Directive, Ofcom has a role in ensuring that a Universal Service Provider is compensated in full for the amount of the net cost which Ofcom has found to be unfair. The draft funding regulations therefore provide a mechanism for dealing with any unpaid contributions.
- 8.18 As with all stakeholders regulated by Ofcom, we would expect contributors to an industry fund to meet their obligation to pay by the given deadline. If there is delay in payment, the provider in question must promptly explain the reasons for the delay. We propose in the draft funding regulations that where an invoice remains unpaid after the deadline for payment specified in the invoice, Ofcom would be able to recover this as a civil debt.¹¹⁰ We intend to take reasonable and proportionate steps to recover unpaid contributions to meet our duty to ensure the Universal Service Provider is fully compensated, which may include pursuing unpaid contributions through the Courts.
- 8.19 Having taken reasonable steps to recover unpaid contributions, the draft funding regulations include a 'backstop' option which enables Ofcom to re-distribute unpaid contributions in certain circumstances amongst the contributors, or a sub-set of them as we deem appropriate.¹¹¹ We consider that this strikes the right balance between taking sufficient steps to recover monies from those who should pay them and ensuring that the Universal Service Provider is compensated fully and in a timely manner. The draft funding regulations provide for this option after a period of at least six months from the deadline for payment has elapsed, which we consider would allow sufficient time for us to take steps to recover any unpaid contributions.
- 8.20 The draft funding regulations also provide that the Universal Service Provider may waive its right to receive sums it would otherwise be entitled to and sets out the way in which this can be done.¹¹² It would be up to the Universal Service Provider to decide whether, in any given circumstances, it is prepared to do so.
- 8.21 Finally, the draft funding regulations specify that where we determine that it would not be appropriate to take further steps to collect and distribute contributions and publish a notification to that effect, the scheme set up to collect industry contributions towards a particular unfair burden would effectively be closed. At this point the draft funding regulations specify that while Ofcom may transfer any contributions it receives to the Universal Service Provider, it cannot take further steps to secure the payment of those contributions and cannot exercise the 'backstop' option referred to above. In our view, it is necessary, in the interests of certainty, that the funding regulations contain a mechanism

¹¹⁰ Draft funding regulation 16(4).

¹¹¹ Draft funding regulation 18(2).

¹¹² Draft funding regulation 19.

for bringing a particular funding process to a close where in our view it would be appropriate to do so.¹¹³

Industry fund annual report

8.22 As we explain in Section 3, where an industry fund is established, the Act¹¹⁴ requires Ofcom to prepare an annual report on the functioning of the fund. This must include details of any determination we make regarding the cost of providing the USO during the reporting period, as well as market benefits accrued by the Universal Service Provider and contributions to a fund. We would publish relevant information each year to meet this requirement.

Summary of draft funding regulations

8.23 We summarise below the process set out in the draft funding regulations for the collection of contributions from industry, and subsequent distribution to the Universal Service Provider. We consider this will provide a sufficient level of detail for the Universal Service Provider and contributors on how the process would operate, while retaining the flexibility to ensure our approach is proportionate to the size of any unfair net cost claim.

8.24 The draft funding regulations are summarised below.

- a) When making determinations concerning the collection and distribution of contributions, we must have regard to the principles of transparency, least market distortion, no undue discrimination and proportionality.
- b) We shall send an invoice to each contributor save for the Universal Service Provider. Providers who receive this invoice shall pay the contribution prescribed in the invoice in the manner and by the deadline specified in the invoice.
- c) Contributors may be permitted to pay the invoice in instalments; we would specify the percentage by which the amount of an unfair net cost will increase if a contributor opts for this method of payment.
- d) The percentage by which the amount of an unfair net cost will also increase if payment of contributions occurs after the relevant date as specified by Ofcom (i.e. the deadline specified in the invoice, at the percentage specified in the invoice).
- e) If a contributor does not pay an invoice after the deadline for payment specified in the invoice, the amount specified in the invoice and any additional amounts in respect of payment of contributions after the relevant date as specified by Ofcom shall be recoverable by us as a debt due from the contributor obliged to pay it.
- f) We would transfer the amounts received from contributors to the Universal Service Provider once per month unless, in our opinion, it would be inappropriate to do so.

¹¹³ Draft funding regulation 20.

¹¹⁴ Section 72(2) of the Act.

- g) If contributors have not paid their contribution by the deadline, a period of at least six months from the deadline for payment has elapsed, the Universal Service Provider has not waived the remaining amount due, and no public funds have been committed to compensating the Universal Service Provider for this sum, we may require additional contributions from the contributors, or such sub-set of them as we deem appropriate.
- h) The Universal Service Provider may waive its entitlement to all or part of the amount to be compensated by sending a notice to us.
- i) Where we determine that it would not be appropriate to take further steps to collect and distribute contributions and publish a notification to that effect, the scheme set up to collect industry contributions towards a particular unfair burden would effectively be closed.

Question 10: Do you agree with our proposed approach to collecting contributions to an industry fund?

Question 11: Do you agree with the proposed process by which we would compensate the Universal Service Provider?

Question 12: Do you have any comments on the specific provisions of the draft funding regulations?

9. Calculation of a net cost for the broadband USO

- 9.1 The legislative requirements relating to a net cost calculation and our proposals for the approach to the calculation and verification exercise are set out in Section 5. We note in Section 5 that the nature of the calculation and verification exercise will depend on the nature, scale and characteristics of a particular set of universal service conditions.
- 9.2 In this section, we set out guidance on how we propose a net cost calculation would be performed for the broadband USO, should a claim be received. In doing so, we explain that our proposed approach is to calculate a net cost:
- a) based on the Net Present Value (“NPV”) of the difference between the cashflows of the Universal Service Provider when operating with the broadband USO and operating without the broadband USO; and
 - b) assuming that, for the purpose of the counterfactual of the Universal Service Provider operating without the broadband USO, there is no alternative provider of the broadband USO.
- 9.3 In Section 5 we propose to specify in the funding regulations information that the Universal Service Provider should be required to submit. In this section we propose to give regulatory financial reporting directions requiring the Universal Service Providers to submit certain specified information for the purposes of the calculation of any net cost associated with the broadband USO. We propose that this information must accompany any request for a review of a net cost of delivering the broadband USO.

The counterfactual for the calculation

- 9.4 As noted in Section 5, the choice of the appropriate counterfactual is an important element of the net cost calculation. The choice of the appropriate counterfactual affects the calculation of a net cost as follows:
- a) Where a Universal Service Provider was operating in the USO area prior to the designation and the appropriate counterfactual envisages that an alternative provider would have been designated to deliver the USO, the Universal Service Provider would lose (at least some) margin to this alternative provider (for example, where new competing services become available). Alternatively, that margin would have been retained had there been no alternative provider(s) designated in the counterfactual.
 - b) Where a Universal Service Provider was not operating in the USO area prior to designation, and was unlikely ever to do so commercially, the counterfactual is one of zero margin for the Universal Service Provider in that area (i.e. in those circumstances the Universal Service Provider would not have margins generated in the USO area which the Universal Service Provider would be at risk of losing if an alternative provider were designated to provide the USO in question).

- 9.5 In the case of the broadband USO, both of the Universal Service Providers, BT and KCOM, were already active in their respective USO designation areas prior to designation. We have therefore considered whether an alternative firm would likely have been designated as the provider of the broadband USO. In other words, we have considered whether the appropriate counterfactual should assume: (i) an alternative provider or providers delivering the broadband USO or (ii) no alternative provider delivering the broadband USO.
- 9.6 As set out in the June 2019 statement,¹¹⁵ in June 2018 we invited expressions of interest to be designated as a Universal Service Provider and received eight responses. We applied a two-stage assessment to the applicants to assess whether they could deliver the broadband USO if designated.
- 9.7 At the first stage of the process, we found that in addition to BT and KCOM only one further provider, Hyperoptic, met our assessment criteria. The criteria included the requirement that: (i) the applicants had the proposed technology to deliver a service that would meet the technical specification of the broadband USO as set out in the 2018 Order; and (ii) the applicants had sufficient sources of funding in place to deliver the broadband USO if designated. Even though Hyperoptic passed the first stage assessment, we felt that we did not have sufficient information to assess it at the second stage (where, amongst other things, we had to assess its operational ability to build the necessary infrastructure to provide the broadband USO connections and to deliver the required service quality). Hyperoptic subsequently withdrew its interest in being designated. As a result of these assessments, we designated the only remaining providers, BT and KCOM, as the Universal Service Providers.
- 9.8 In light of the above, for the broadband USO we propose that the appropriate counterfactual should assume that no alternative provider(s) would have been designated to provide the broadband USO in the areas where BT and KCOM have been designated.

The use of NPV methodology in the calculation

- 9.9 As set out above, where no alternative provider(s) would have been designated, a net cost of providing a USO should reflect the net cost of operating with the universal service obligations after allowing for benefits.

NPV methodology

- 9.10 Our proposed approach to the calculation of a claimed net cost is set out at a high level in Section 5. In the case of the broadband USO, we expect a significant proportion of any capital expenditure to be incurred as the upgraded connections are built, which we expect will occur relatively quickly. However, some incremental costs (or savings) and a significant proportion of the benefits are likely to occur over the lifetime of the assets, which in this case may be more than 20 years for certain parts of the infrastructure built.

¹¹⁵ Paragraphs 4.5 and 4.9 – 4.10 of the June 2019 statement.

- 9.11 A NPV methodology allows for the net value of expected costs and benefits to be calculated, with the timing of cashflows taken into account by applying a discount rate to future cashflows. In the event of a net cost (i.e. a negative NPV), this framework can also be used to calculate the amount of compensation as a lump-sum that would be necessary to deliver a break-even investment. That is, a NPV of zero, which in principle should represent the difference in a net cost of operating with and without the USO.
- 9.12 A NPV calculation can be carried out at any point in the asset lifetime and has the advantage that a net cost, over the whole lifetime of the assets, can be assessed in one calculation. This will avoid the need for multiple calculations over the lifetime of the asset. A NPV calculation undertaken before costs and revenues have been incurred will rely more heavily on forecasts of future cashflows. Given we expect that the bulk of any net cost will consist of capital expenditures incurred relatively early in the process, the risk of material forecasting errors is reduced in this instance.
- 9.13 A NPV is not the only way to measure a net cost and may not be our approach in other cases. For example, a net cost could be calculated and/or compensated on an ongoing basis over the lifetime of the USO, by calculating the net cost for a defined period based on depreciation and a return on assets. This approach would rely less heavily on forecasts but could still rely on assumptions regarding the profile of depreciation over time which can be difficult to determine accurately in cases where the bulk of the costs is caused by new assets being laid down. Such an ongoing evaluation could also be a more burdensome approach as it will necessitate further periodic calculations into the future.
- 9.14 Given the relatively small size of the broadband USO, that it will require new assets and the fact that much of any net cost will be incurred relatively early in the lifetime of those assets, we propose to use a NPV framework to calculate any net cost. We consider an approach based on depreciation and return on assets would not be appropriate in this instance.

Expenditure to date

- 9.15 Most of the costs incurred prior to the date of any claim will be in the form of capital expenditure.
- 9.16 Our starting point is that we would expect the Universal Service Provider to seek to provide broadband services in the USO areas on the same commercial terms as are available outside the USO areas. Where this is the case, we would expect most of the direct (or ongoing) costs and revenues of providing a broadband USO service to be similar to those of providing a service on a commercial basis. Therefore, we would expect the ongoing costs and revenues for broadband USO connections and services would be similar to those for commercial services, although the upfront costs may be higher.
- 9.17 We will include forecast capital expenditure if the Universal Service Provider can demonstrate that such expenditure will necessarily be incurred for the ongoing provision of built broadband USO connections and services (not speculative or prospective connections or services) and the asset replacement cycle is reasonable.

9.18 In respect of the broadband USO specifically, we propose that any capital expenditure incurred prior to the Universal Service Provider being designated in relation to shared assets, such as ducts, which are then used to provide broadband USO services will be excluded. However, where existing assets have been extended or improved to provide broadband USO connections and services, we propose that these post designation costs should be considered as part of a net cost calculation.

Future cashflows

9.19 In respect of operating costs in relation to the broadband USO, these would only be included to the extent that they will not be offset by the avoidance of other operating costs that would otherwise have been incurred. For example, pre-USO operating costs of an old technology may be higher than the operating costs of the new technology.

9.20 While the level of operating costs could increase (e.g. if additional activities were necessary), we consider it more likely that they will decrease in light of the evidence gathered during various market reviews which shows that cost efficiencies tend to be realised following the investment in new equipment and technology. Operating cost savings would reduce a net cost of the broadband USO, all other things being equal.

9.21 Building new connections will likely cause incremental changes in revenues earned by the Universal Service Provider. These could include additional revenues from higher speed services (as higher speed services are typically charged at a premium to slower speed services) or additional revenue from services the Universal Service Provider may sell as part of a package accompanying a higher speed broadband connection (e.g. pay-TV services) made possible or improved when delivered over a higher speed connection. These incremental revenues would reduce a net cost of the broadband USO, all other things being equal.

9.22 It is also possible that our assumptions relating to future take up of broadband USO connections and services will differ from those used for the purposes of demand aggregation, as they will reflect more up to date information.

9.23 The Universal Service Directive explains that taking intangible benefits into account means that an estimate, in monetary terms, of the indirect benefits that an undertaking derives by virtue of its position as the Universal Service Provider, should be deducted from the direct net cost of the USO in order to determine the overall cost burden.¹¹⁶

9.24 Potential intangible benefits include those related to enhanced brand recognition, the benefits of increased ubiquity of the service, and lifecycle benefits. However, in the context of the broadband USO specifically, we do not expect these benefits to be significant given the expected small size of the broadband USO and in light of the fact that BT and KCOM are already designated as Universal Service Providers for the telephony USO.

9.25 The assumptions included in our forecasts will be informed by data supplied by the Universal Service Provider with the request, but we will not rely solely on this data. We will

¹¹⁶ Recital 20 of the Universal Service Directive.

also take account of other relevant information in relation to the cost and revenues of deploying the technology used to deliver broadband connections, for example information acquired from the Universal Service Provider or other providers when undertaking other regulatory functions (such as market reviews) or market monitoring.

- 9.26 Depending on the scale of the claim and the nature of the available evidence, we may estimate future cash flows using a margin per line scaled by forecast line volumes. This would mean calculating the future cashflow based on an estimated margin contribution per service or average service.¹¹⁷ If we adopt this approach, we will set out our assumptions and basis for the margin as part of any consultation on a draft determination of a net cost assessment.

The choice of discount rate

- 9.27 We recognise that Universal Service Providers will need the opportunity to earn an appropriate rate of return on USO investments to reflect the opportunity cost of capital for such investments. Providing the opportunity to earn such a rate of return is consistent with the principle that the USO should be cost neutral for a Universal Service Provider i.e. they should not have a cost advantage or disadvantage from delivering the USO.
- 9.28 We propose that future cash flows should be discounted using the Weighted Average Cost of Capital (“WACC”) associated with the relevant line of business. Where available, we propose to use the WACC from a regulatory decision (e.g. a charge control) applicable to the line of business in question, at or around the time of the main capital expenditure programme for the USO. We propose to use a WACC consistent with the financial modelling of any future cashflows – i.e. consistent with whether cashflows are in real or nominal terms, and whether they are pre- or post-tax.

Maintenance of records and reporting requirements

- 9.29 In the June 2019 statement¹¹⁸, we imposed universal service conditions on BT and KCOM which require the following.
- a) The Universal Service Providers must maintain records for a minimum period of six years from the date on which these records are created. These records must be sufficient to: (i) demonstrate the Universal Service Providers’ compliance with the universal service conditions; and (ii) provide adequate evidence and explanations in support of any potential request made by them for compensation for complying in relation to any one or more of the universal service conditions applied to them.¹¹⁹

¹¹⁷ We have allowed for this possibility in the [template](#) in [Annex 6](#).

¹¹⁸ See paragraph 9.89 of the June 2019 statement.

¹¹⁹ Universal service conditions F.1 of Schedules 1 and 3 of Ofcom’s notification which was contained in Annex 1 to the June 2019 statement.

These obligations require the Universal Service Providers to ensure that they retain sufficient information including source data such as invoices, vouchers, and timesheets.

- b) The Universal Service Providers must separately record actual costs, revenues, and assets associated with the provision of USO services.¹²⁰ As a result of this obligation, the Universal Service Providers are required to be able to demonstrate how they have calculated the incremental cost and revenue elements, and explain the transactions underlying the cost of providing broadband USO connections.
- c) The Universal Service Providers must comply with all such reporting requirements as Ofcom may from time to time direct under those universal service conditions.¹²¹

Proposed broadband USO regulatory financial reporting directions

9.30 As explained above, we specify in the draft funding regulations information that the Universal Service Providers should be required to submit for all USOs. In addition to that, we consider that it would be appropriate to give directions to BT and KCOM under universal service conditions F.3 which would set out certain information that must be provided in relation to the broadband USO specifically in the event that BT and/or KCOM decide to make a request for compensation.¹²²

9.31 We propose in the draft directions included in [Annex 6](#) that the information that is required to be provided to Ofcom must include a calculation of the NPV as this reflects our proposed approach to performing a net cost calculation for the broadband USO as outlined above. The appropriate timeframe over which the NPV is calculated would depend on what assets have been laid down and are included within each specific claim. The draft directions do not set out a specific timeframe and this will be a matter for the Universal Service Provider in the first instance. Under our proposals, the NPV calculation will contain:

- a) a total amount of all cash costs incurred and/or avoided in complying with the relevant universal service conditions, broken down by actual cash costs before the request is made and an estimate of future cash costs from that date going forward; and
- b) a total amount of all revenues and/or other benefits received and/or foregone in complying with the relevant universal service conditions, broken down by revenues and/or other benefits before the request is made and an estimate of future revenues and/or other benefits from that date going forward.

¹²⁰ Universal service conditions F.2 of Schedules 1 and 3 of Ofcom's notification which was contained in Annex 1 to the June 2019 statement.

¹²¹ Universal service conditions F.3 of Schedules 1 and 3 of Ofcom's notification which was contained in Annex 1 to the June 2019 statement.

¹²² Where we refer to "a request for compensation for complying in relation to any one or more of the universal service conditions" in the universal service conditions and directions, this is equivalent to "a request for a review of the extent (if any) of the financial burden of complying in relation to any matter with any one or more of the universal service conditions" in section 70(1) of the Act and the draft funding regulations.

- 9.32 The reason for requiring the provision of this information is to support our assessment of any request which may be made by BT and/or KCOM by ensuring that we have access to the relevant information and explanations.
- 9.33 We appreciate that the Universal Service Providers would be unable to include actual costs, revenues and/or other benefits up to the exact date on which they submit any request for compensation given that they would need to ensure appropriate internal review and governance processes before any such submission is made. We have therefore proposed that the Universal Service Providers must provide actual figures up to a cut-off date which is as close as reasonably practicable to the date of their request, taking account of the availability of the most up-to-date actual figures to be used in their NPV calculations.
- 9.34 The proposed requirements to provide the information specified in the directions would be in addition to further obligations on BT and KCOM to supply further information under the draft funding regulations and universal service conditions in the event that BT and/or KCOM decide to make a request for compensation. We have explained this in the proposed directions.

Legal tests

- 9.35 For the reasons set out above and summarised below, we are satisfied that the proposed directions (as set out in [Annex 6](#)) meet the relevant tests set out in the Act. When imposing directions under section 49 of the Act in a particular case, we must be satisfied that the legal tests in section 49(2) of the Act are met. We consider that the proposed directions are:
- a) objectively justifiable, in that they seek to ensure that the Universal Service Providers provide to Ofcom appropriate information to support any request for compensation they may make so that Ofcom is able to discharge its duties in respect of funding of any unfair burden associated with the broadband USO; the proposed obligations therefore seek to ensure that Ofcom has sufficient information to assess and verify any possible future claims for funding of the broadband USO as required by the legislation;
 - b) not unduly discriminatory, as the obligations are proposed to apply to BT and KCOM as the Universal Service Providers who are entitled to make a request for compensation;
 - c) proportionate, since we have balanced the need to ensure that the obligations are not unduly burdensome for the Universal Service Providers with the need to ensure that Ofcom has sufficient information to assess and verify any possible future claims for funding of the broadband USO; and
 - d) transparent, in that the proposed directions are clear about what information the Universal Service Providers would be required to provide to Ofcom and the format in which this information should be supplied; further, we have sought to be transparent in devising the directions through public consultation.
- 9.36 We also consider that the proposed directions meet our duties and the Community requirements under sections 3 and 4 of the Act. They further the interests of citizens in

relation to the communications matters and the interests of consumers in the relevant markets as well as promote the interests of EU citizens because they seek to ensure that we have sufficient information to assess and verify any future claims for funding of the broadband USO. This will help ensure that Ofcom is able to discharge its duties in this area.

Question 13: Do you agree with our proposed approach to the choice of the counterfactual for the calculation of a net cost of the broadband USO?

Question 14: Do you agree with our proposal to use a NPV methodology to calculate a net cost of the broadband USO?

Question 15: Do you agree with our proposed reporting requirements in respect of the broadband USO?

Question 16: Is there anything else you would like to tell us about the proposals set out in this document?

The overview section in this document is a simplified high-level summary only. The proposals we are consulting on and our reasoning are set out in the full document.

A1. Responding to this consultation

How to respond

- A1.1 Ofcom would like to receive views and comments on the issues raised in this document, by 5pm on 7 January 2020.
- A1.2 You can download a response form from <https://www.ofcom.org.uk/consultations-and-statements/category-2/compensating-providers-delivering-universal-services>. You can return this by email or post to the address provided in the response form.
- A1.3 If your response is a large file, or has supporting charts, tables or other data, please email it to Broadband.USO@ofcom.org.uk, as an attachment in Microsoft Word format, together with the [cover sheet](#).
- A1.4 Responses may alternatively be posted to the address below, marked with the title of the consultation:
- Nicola Jayawickreme
Ofcom
Riverside House
2A Southwark Bridge Road
London SE1 9HA
- A1.5 We welcome responses in formats other than print, for example an audio recording or a British Sign Language video. To respond in BSL:
- Send us a recording of you signing your response. This should be no longer than 5 minutes. Suitable file formats are DVDs, wmv or QuickTime files. Or
 - Upload a video of you signing your response directly to YouTube (or another hosting site) and send us the link.
- A1.6 We will publish a transcript of any audio or video responses we receive (unless your response is confidential).
- A1.7 We do not need a paper copy of your response as well as an electronic version. We will acknowledge receipt if your response is submitted via the online web form, but not otherwise.
- A1.8 You do not have to answer all the questions in the consultation if you do not have a view; a short response on just one point is fine. We also welcome joint responses.
- A1.9 It would be helpful if your response could include direct answers to the questions asked in the consultation document. The questions are listed at Annex 4. It would also help if you could explain why you hold your views, and what you think the effect of Ofcom's proposals would be.
- A1.10 If you want to discuss the issues and questions raised in this consultation, please contact Nicola Jayawickreme on 020 7981 3960, or by email to Broadband.USO@ofcom.org.uk.

Confidentiality

- A1.11 Consultations are more effective if we publish the responses before the consultation period closes. In particular, this can help people and organisations with limited resources or familiarity with the issues to respond in a more informed way. So, in the interests of transparency and good regulatory practice, and because we believe it is important that everyone who is interested in an issue can see other respondents' views, we usually publish all responses on [the Ofcom website](#) as soon as we receive them.
- A1.12 If you think your response should be kept confidential, please specify which part(s) this applies to, and explain why. Please send any confidential sections as a separate annex. If you want your name, address, other contact details or job title to remain confidential, please provide them only in the cover sheet, so that we don't have to edit your response.
- A1.13 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and try to respect it. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.
- A1.14 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's intellectual property rights are explained further in our [Terms of Use](#).

Next steps

- A1.15 Following this consultation period, Ofcom plans to publish a statement in spring 2020.
- A1.16 If you wish, you can [register to receive mail updates](#) alerting you to new Ofcom publications.

Ofcom's consultation processes

- A1.17 Ofcom aims to make responding to a consultation as easy as possible. For more information, please see our consultation principles in Annex 2.
- A1.18 If you have any comments or suggestions on how we manage our consultations, please email us at consult@ofcom.org.uk. We particularly welcome ideas on how Ofcom could more effectively seek the views of groups or individuals, such as small businesses and residential consumers, who are less likely to give their opinions through a formal consultation.
- A1.19 If you would like to discuss these issues, or Ofcom's consultation processes more generally, please contact the corporation secretary:

Corporation Secretary
Ofcom
Riverside House
2a Southwark Bridge Road
London SE1 9HA
Email: corporationsecretary@ofcom.org.uk

A2. Ofcom's consultation principles

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

Before the consultation

- A2.1 Wherever possible, we will hold informal talks with people and organisations before announcing a big consultation, to find out whether we are thinking along the right lines. If we do not have enough time to do this, we will hold an open meeting to explain our proposals, shortly after announcing the consultation.

During the consultation

- A2.2 We will be clear about whom we are consulting, why, on what questions and for how long.
- A2.3 We will make the consultation document as short and simple as possible, with a summary of no more than two pages. We will try to make it as easy as possible for people to give us a written response. If the consultation is complicated, we may provide a short Plain English / Cymraeg Clir guide, to help smaller organisations or individuals who would not otherwise be able to spare the time to share their views.
- A2.4 We will consult for up to ten weeks, depending on the potential impact of our proposals.
- A2.5 A person within Ofcom will be in charge of making sure we follow our own guidelines and aim to reach the largest possible number of people and organisations who may be interested in the outcome of our decisions. Ofcom's Consultation Champion is the main person to contact if you have views on the way we run our consultations.
- A2.6 If we are not able to follow any of these seven principles, we will explain why.

After the consultation

- A2.7 We think it is important that everyone who is interested in an issue can see other people's views, so we usually publish all the responses on our website as soon as we receive them. After the consultation we will make our decisions and publish a statement explaining what we are going to do, and why, showing how respondents' views helped to shape these decisions.

A3. Consultation coversheet

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

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

Nothing

Name/contact details/job title

Whole response

Organisation

Part of the response

If there is no separate annex, which parts? _____

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

DECLARATION

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

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

Name

Signed (if hard copy)

A4. Consultation questions

Question 1: Do you agree with our proposed procedures for commencing a review of a net cost of complying with universal service conditions?

Question 2: Do you agree with our proposed procedures for making an application requesting compensation for any unfair burden?

Question 3: Do you agree with our proposed procedures when making determinations when assessing a net cost claim, including our proposed approach to finality?

Question 4: Do you agree with our proposal on the information the Universal Service Provider should provide alongside an application to review a net cost?

Question 5: Do you agree with our proposed approach to calculating, verifying and auditing a net cost?

Question 6: Do you agree with the proposed factors we will consider when assessing an unfair burden?

Question 7: Do you agree with our proposed approach to determining whether an industry fund should be set up?

Question 8: Do you agree with our proposed approach to determining which providers will contribute to any industry fund?

Question 9: Do you agree with our proposed approach on calculating contributions from fund contributors?

Question 10: Do you agree with our proposed approach to collecting contributions to an industry fund?

Question 11: Do you agree with the proposed process by which we would compensate the Universal Service Provider?

Question 12: Do you have any comments on the specific provisions of the draft funding regulations?

Question 13: Do you agree with our proposed approach to the choice of the counterfactual for the calculation of a net cost of the broadband USO?

Question 14: Do you agree with our proposal to use a NPV methodology to calculate a net cost of the broadband USO?

Question 15: Do you agree with our proposed reporting requirements in respect of the broadband USO?

Question 16: Is there anything else you would like to tell us about the proposals set out in this document?

A5. Draft funding regulations

A5.1 We have published the [draft funding regulations](#) alongside this consultation.

A6. Draft directions on financial reporting

A6.1 We have published the [draft directions](#) alongside this consultation.

A7. Draft guidance on calculating net relevant turnover

A7.1 This annex provides guidance on the calculation of net relevant turnover for the purposes of calculating the amount of any contributions that are due to an industry fund. In particular, it discusses the deductions that should be made to relevant turnover, in order to arrive at the net relevant turnover figure that will form the basis of the calculations of contributions to an industry fund.

Relevant turnover

A7.2 The starting point for calculating the net relevant turnover is at the determination of the relevant turnover.

A7.3 Relevant turnover is any turnover resulting from ‘relevant activities’, carried out wholly or partly in the UK. Relevant activities include:

- a) the provision of Electronic Communications Services (“ECS”) to third parties;
- b) the provision of Electronic Communications Networks (“ECN”), ECS and network access to communications providers; or
- c) the making available of associated facilities to communications providers.

A7.4 Relevant turnover should be calculated in accordance with Ofcom’s guidance on establishing relevant turnover for the purposes of administrative charging.¹²³ It should be noted that the ECN/ECS providers, who are subject to Ofcom’s administrative levy, already produce a relevant turnover calculation (for the purpose of determining the levy due).

A7.5 Net relevant turnover is calculated by subtracting ‘allowable deductions’ from the relevant turnover figure. The general principles for determining which costs amount to allowable deductions are set out below.

Allowable deductions

A7.6 As set out in Section 7, we propose to use net relevant turnover to calculate contributions to avoid the double imposition of contributions on the inputs and the outputs of undertakings.¹²⁴ This is achieved by deducting payments made to other providers for inputs which already form the basis of a contribution to an industry fund by that supplier.

A7.7 We also set out in Section 7 that the scope of an industry fund could include all providers of ECN and ECS, but that it could also be restricted to a particular description of providers. Where that is the case, revenues generated from the supply of ECN and ECS that are

¹²³ The guidance for calculating relevant turnover is available on the Ofcom website [here](#).

¹²⁴ Annex IV of the Universal Service Directive.

determined to be out of scope will not form the basis of contributions to an industry fund and can be deducted from the relevant turnover of all suppliers.

- A7.8 In order to avoid contributions being imposed on both the inputs and outputs of undertakings a deduction is also allowable for a payment made to a third party for ECN/ECS, where that payment will form part of the relevant turnover of another contributor. In other words, these allowable deductions are effectively wholesale payments which form part of the relevant turnover of other undertakings and so already form the basis of a contribution to an industry fund.
- A7.9 We consider that as ECN/ECS providers are already required to follow Ofcom's guidance on establishing relevant turnover for the purposes of administrative charging, they should be able to identify (with reasonable accuracy) the subset of payments made to ECN/ECS providers that will feature in that provider's relevant turnover submission. To determine which payments already form part of the basis for a contribution to the industry fund; providers will also need to specify the identity of the providers from which ECN/ECS have been purchased, so that deductions can be matched to the list of contributors.

A8. Glossary

Access network An electronic communications network which connects end-users to a service provider running from the end-user's premises to a local access node and supporting the provision of access-based services. It is sometimes referred to as the 'local loop' or the 'last mile'.

Allowable deductions include payments made to other providers for inputs which already form the basis of a contribution to an industry fund, as well as the revenues from relevant activities which are determined to be out of scope to form the basis of contributions to the fund.

Bandwidth The maximum amount of data that can be transmitted along a channel.

Broadband A service or connection generally defined as being 'always on', providing a bandwidth greater than narrowband.

Broadband speed The speed at which data are transmitted over a broadband connection, usually measured in megabits per second (Mbit/s).

Broadband universal service The broadband connections and services of specified quality brought within the scope of the universal service by the 2018 Order.

Broadband USO Introduced by the 2018 Order to give homes and businesses the right to request a decent and affordable broadband connection.

Contention ratio The degree to which bandwidth is shared between different end-users at the same network node. When more end-users share the same bandwidth within a network this can lead to a slowdown in performance.

DCMS Department for Digital, Culture, Media and Sport.

Decent broadband A broadband connection that enables full and effective social and economic participation in a digital society, which was defined in the 2018 Order as a line capable of delivering at least 10Mbit/s download and 1Mbit/s upload sync speeds (as well as having other specified characteristics).

Download speed Also downlink or downstream speed. Rate of data transmission from a network operator's access node to a customer, typically measured in Mbit/s.

ECN Electronic Communications Networks, as defined in section 32 of the Act.

ECS Electronic Communications Services, as defined in section 32 of the Act.

Excess costs Any costs of providing a broadband connection which are more than £3,400 excluding VAT.

Fibre to the Cabinet (FTTC) Access network consisting of optical fibre extending from the access node to the street cabinet. The street cabinet is usually located only a few hundred metres from the subscribers' premises. The remaining segment of the access network from the cabinet to the customer is usually a copper pair.

Fibre to the Premises (FTTP) A form of fibre optic communication delivery in which the optical signal reaches the end-user's home or business. Also known as full-fibre broadband.

Fixed broadband Broadband delivered over a fixed line to a customer's premises.

Fixed Wireless Access (FWA) Broadband delivered over radio waves to a customer's premises.

Latency The time it takes a single packet of data to travel from a user's PC to a third-party server and back again. The figure is most commonly measured in milliseconds, and a connection with low latency will feel more responsive for simple tasks like web browsing.

Mbit/s Megabits per second. A unit measuring the bit-rate.

Net cost The cost of complying with one or more universal service conditions less the direct and indirect benefits of being designated as a Universal Service Provider.

Net Present Value (NPV) The present value of a stream of cashflows over time.

Net relevant turnover is calculated by subtracting allowable deductions from the relevant turnover figure.

Number-Independent Interpersonal Communications Services (NIICS) 'Over the top' services brought within scope of the definition of ECS by the Code.

Reasonable cost threshold A cost threshold set by Government in the 2018 Order to determine eligibility for the broadband USO. A Universal Service Provider is not obliged to supply a broadband USO connection, where the cost of providing that connection exceeds £3,400; unless the end-user pays the excess costs over £3,400.

Relevant activities Relevant activities include the provision of ECS to third parties; the provision of ECN, ECS and network access to communications providers; or the making available of associated facilities to communications providers.

Relevant turnover The turnover that an undertaking generates from relevant activities, carried out wholly or partly in the UK.

Sync speed The modem sync speed is the maximum speed achievable between a consumer's premises and their internet service provider's network.

Telephony universal service The publicly available telephone services and other specified services set out by the 2003 Order which must be provided, made available or supplied throughout the UK.

Universal Service Directive European Parliament and Council Directive (EC) 2002/22 (OJ L108, 24.4.2002) on universal service and users' rights relating to electronic communications networks and services.

Universal Service Provider For both the telephony and broadband USO, KCOM has been designated as the Universal Service Provider for the Hull area, and BT as the Universal Service Provider for the rest of the UK.

USO Universal Service Obligation.

The 2003 Order The Electronic Communications (Universal Service) Order 2003 as amended by the 2018 Order.

The 2018 Order The Electronic Communications (Universal Service) (Broadband) Order 2018.

The Act The Communications Act 2003 as amended.

The Code Directive (EU) 2018/1972 of the European Parliament and of the Council of 11 December 2018 establishing the European Electronic Communications Code.

Upload speed Also uplink or upstream speed. Rate of data transmission from a customer's connection to a network operator's access node, typically measured in Mbit/s.

Weighted Average Cost of Capital (WACC) Weighted average cost of capital typically estimated as an average of the company's cost of equity and cost of debt weighted by gearing.