Clarifications provided to stakeholders

1. V4 1.20c discusses how (under CPI+0 indexation) post-entry prices “will be driven by competition”. Are Ofcom referring here to BT pricing below the price cap?

Yes. This is a reference to stakeholder arguments that Openreach will price below the cap as a result of competition.

2. V2 1.21 Ofcom say that there is a “significant and positive relationship between higher wholesale prices and network build”. Do Ofcom have any evidence to support or quantify this?

We presume this is a reference to V4 rather than V2. The basis for this view is set out in the preceding paragraphs, notably paragraphs 1.3-1.10 and 1.16-1.24.

3. I don’t follow the last sentence of V4 1.52. Could you unpack/explain the logic?

V4, 1.52 considers the incentives on telecoms providers that are currently reliant on Openreach’s wholesale services, e.g. Sky and TalkTalk. The suggestion being tested is that these providers will be incentivised to build a network themselves, or to do a deal with an alternative provider who will build a network, if they know that Openreach’s prices will increase after a competitive network has been built.

The conclusion is that getting Openreach to increases its prices post competitive build does not obviously change the incentives on these providers.

By way of example, a competitive network will either be able to match Openreach’s prices profitably or it will not be able to. If the competitive network cannot match Openreach’s prices, we do not believe that these providers will pursue building a competitive network. Having higher post-build Openreach prices seems irrelevant, as the competitive network will not get built and thus these higher prices will never materialise. We therefore consider the alternative case, where the competitive network is able to match or undercut the Openreach price.

If the competitive network can match or undercut Openreach’s price then it would be better for these providers to build a competitive network than buy from Openreach. However, this is true regardless of Openreach’s post-build prices.

4. Openreach investment incentive (V4 1.56-1.57). Ofcom have assumed that in areas where there is altnet threat that this is the dominant factor affecting OR investment incentive. What is Ofcom’s view on the impact of higher copper wholesale prices in areas where there is no or weak altnet FTTP threat?

See paragraph 1.24, which states “We agree that higher FTTC prices will increase the relative profitability of remaining on FTTC compared to investing in FTTP, all else equal.”

5. V4c1.59 Ofcom says problem with price floor was that (in long run) may "artificially inflate prices" and result in excessive prices. Are Ofcom referring here to a situation where (in areas where altnets invest) the floor is set too high or that the price is set above the floor?

- If the concern is the former (that the floor is set too high) does this concern not equally apply to CPI+0 indexation?
- If the concern is the latter (that prices may be set above the floor) have Ofcom considered the suggestion we made in our June response for a cap above the floor?

The concern is the former (that the floor is set too high). See A15.86. In relation to our proposal to cap Openreach's charges at CPI+0, we invite TalkTalk to set out its views on this in response to the consultation.

6. V4 1.61 discusses imposing a price floor. Is this the "potential legal issues" with adaptive regulation that is referred to in V4 1.74. If not what are the legal issues?

Yes, the potential legal issues referred to at 1.74 are those discussed in relation to a price floor at 1.61.

7. In V4 1.61 Ofcom says that to impose a price floor Ofcom "would need to be satisfied that the floor is necessary to address the risk that Openreach might engage in excessive pricing or a margin squeeze". We do not understand this since generally a floor is aimed at preventing predation at the wholesale level rather than excessive wholesale prices (or a downstream margin squeeze).

Our power to set a price control as a SMP condition derives from section 87(9) of the Communications Act 2003, and is subject to section 88.

Section 88(1)(a) provides that we may only set such a condition where (among other things) it appears to us that there is a relevant risk of adverse effects arising from price distortion.

Section 88(3) provides that there is such a relevant risk if the dominant provider might (a) fix and maintain some or all of his prices at an excessively high level, or (b) impose a price squeeze, so as to have adverse consequences for end-users of public electronic communications services.

To exercise our power to impose a price control as a SMP condition, we would therefore need to be satisfied that the floor is necessary to address one of these risks.

8. Does Ofcom have a view on the impact of the various options if the area that is 'prospectively competitive' is in practice materially smaller or larger than Ofcom forecasts (i.e. forecast error)?

We recognised the uncertainty around investment plans, for example as stated in V2 7.43 and 8.47, and took this into account when developing our remedies proposals.

9. V4 1.93 Is, in its analysis, Ofcom implicitly assuming that altnets will pass an additional 5m homes as a result of Ofcom's pricing approach? Is the cost based on £1.50 pm x 21m homes for period 2021-2026 and benefit £1.50 pm x 5m homes from 2021 in perpetuity?

The simple illustrative calculation used in paragraph 1.93 is based on benefits if 5 million premises are passed by new rival networks.

The detail of the calculation is set out in footnote 31. The cost is calculated as £1.50 per month x 21.3m lines, for five years. The benefits assume 1 million homes will be passed each year for 5 years. For each 1 million homes, the benefits are calculated as £1.50 per month x 1m homes in perpetuity (the calculation takes into account when the homes are passed i.e. not all rollout is assumed in the first year).

10. V4 1.66 Ofcom says that "allowing Openreach to earn revenues somewhat above its costs would provide direct support for Openreach's own FTTP rollout". Is Ofcom suggesting here that Openreach will increase its FTTP build if it makes higher profits on copper products since it will transfer the additional funds to FTTP build?

In paragraph 1.66, we are noting that higher profits on copper products could be used to by Openreach to fund its own FTTP rollout.

11. Can you describe how you calculated the flat real annuity in your price-cost test in Area 2 using the fibre cost model?

We set out the steps below.

Step 1: Calculating the stream of relevant cash costs over 20-year period (including terminal value)

1. We take the capex outputs from row 7 in the 'Checks' tab of the 'Cost Recovery' module and subtract customer equipment capex in row 12 in the same tab.
2. We take the opex outputs from row 83 in the 'Checks' tab of the 'Cost Recovery' module and subtract L2C opex in row 86 in the same tab.
3. We then add the capex and opex to calculate total cash costs over a 20 year period.
4. We then add a terminal value after year 20 equal to the cash cost in year 20 divided by the real pre-tax WACC.

Step 2: Calculating the stream of volumes over 20-year period (including terminal value)

1. We take the forecast volumes (FTTP lines) over the same 20-year period.
2. We then add a terminal value after year 20 equal to the volume in year 20 divided by the real pre-tax WACC.

Step 3: Calculating the flat real annuity

1. We compute the PV of the stream of cash costs over the 20-year period including the terminal value.
2. We then spread the PV of cash costs over the forecast volumes (weighted by the discount rate) by dividing the PV of the cash costs over the PV of volumes over the 20-year period including the terminal value of volumes. This is similar to what we do when calculating economic depreciation.

3. This results in a flat real annuity as at 2019/20.
4. We then uplift the figure above to convert to a flat real annuity as at 2020/21 using our CPI index forecast for 2019/20 and 2020/21.