Vodafone response to Ofcom's Wholesale Fixed Telecoms Market Review

Further consultation on certain proposed remedies

Non - Confidential

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Executive summary

1. This is the forth sub-consultation that has been published directly following Ofcom's main Wholesale Fixed Telecoms Market Review, which closed in the spring. In each of these four WFTMR sub-consultations, Ofcom has re-consulted to revise specific remedies, seeking to overturn what was proposed in the original market review and without exception, move Ofcom"s proposals towards the views of Openreach.

2. We have seen Ofcom propose to accept Openreach's 'offer' for a non-binding limited build commitment for Area 3, in return for much lighter regulation. Then we have had Openreach's request for an early end to copper regulation in some exchange areas, with permission to raise copper prices before the end of the market review period proposed. We've seen softer QoS standards suggested, again all at the behest of Openeach. This consultation is no exception, with material price rises proposed for Duct and Pole Access and Dark Fibre, again under the direct influence of Openreach. In contrast, Ofcom appeared to have thus far ignored the very compelling and significant body of evidence that support moving the broadband anchor to 80/20 and have failed to take into account the damage that +CPI price increases will do to consumer finances, without any upside benefits in fibre build. There has also been no answers forthcoming on taking measures to protect the role that WLR plays in underpinning consumer broadband ahead of fibre roll out.

3. Needless to say, we are deeply concerned at the overall trajectory of the market review and the influence that SMP provider Openreach appears to have on the process. We would urge Ofcom to take a step back and consider carefully how it approaches these matters, as the decisions it takes will have a direct impact on UK consumers and their finances in the decade ahead. There will be no future opportunities to recant these proposals, which all have their origins with Openreach, rather than a broader set of stakeholders.

4. Ofcom's overall policy is to encourage competitive build., with Ofcom's estimates suggested that circa 70% of the population will be competitively served. Ofcom's pricing proposals for active services are designed to encourage alternative infrastructure build. The latest data from Openreach supports the view that many organisations are seeking to build their services independently using Openreach ducts. Presently 90 CPs have completed the Openreach service establishment process which enables them to use the Openreach duct system. Openreach estimate that this will reach 100 CPs by the close of the year. CPs are rolling out networks in line with their service strategy. This means that leased lines operators are using duct access to fulfill leased line installations and FTTP

operators are using the ducts for FTTP build. The adherence to building in line with current business strategy / competency means that ducts will include overbuild facilities specific to market segments and ultimately result in greater levels of overbuild. Ofcom's policy of promoting competition and the evidence of organisations preparing to use ducts both point to an expectation of reasonable to high duct utilisation.

5. This consultation broadly proposes that PIA prices should now rise by approximately 50% over the review period and that dark fibre prices should increase by between 20% and 60%. Over the last 10-15 years when Ofcom have been actively implementing price controls on wholesale products we have never experienced such a shift in proposed regulated prices from one consultation to another for the same products in the same market review period. As we explain below, these changes are purely based on the views of BT and Openreach. Openreach has updated its views directly in line with its best commercial interests and will enjoy additional revenues and profits should their views prevail.

PIA pricing now set to increase by approximately 50% over the review period

Question 3.1: Do you agree with our revised proposals relating to calculating the shares of unit costs to be reflected in PIA rental charges? Please set out your reasons and supporting evidence for your response

6. In the January 2020 consultation Ofcom proposed the price for spine duct, the main DPA product that drives CPs' cost base would remain flat. The consultation proposed that spine duct is subject to a CPI-2% charge control, which taking a reasonable estimate of CPI (at approximately 2%) means that in reality spine duct is likely, in real terms, to be subject to very small actual price fluctuations.

7. In Ofcom's latest consultation the proposal is for a spine duct price increase by CPI+3.9% or 1.4%, assuming CPI is 2%. This means that prices will increase by approximately 3.4-5.9% each year and rise by well over 30% over the review period.

8. These revised proposals are solely based on responses from BT. Although this is stating the obvious, it is nevertheless worth mentioning, BT Group and Openreach have a direct commercial interest in increasing DPA prices. Price increases directly translate into high profits for Openreach and BT Group.

9. We did not respond specifically or in any detail to the PIA pricing proposed in the original January consultation. The reason we did not respond is because we were broadly content with the prices proposed, which had in fact only been set and established in 2018 and we considered that

consistency and predictability is one of the most important elements of PIA pricing. We also considered that pricing in the market, which was set in 2018 must have been set at the appropriate level because product uptake from operators in the market since 2018 has been fierce and plentiful.

10. If Ofcom are to review PIA pricing and the methodology used to set the prices they must carry out a complete review and not simply adjust prices one way to take on the views of a self-serving incumbent operator. We will address BT's and Openreach's specific response later on and explain why their proposals are narrow sighted, however firstly we believe it is important to revisit the whole basis of what cost base should be used to set PIA prices.

11. The EC issued recommendations on costing methodologies for use in broadband in 2013. The recommendation sets out the appropriate methodologies to use in modelling the costs of physical infrastructure, distinguishes these from the methodologies applicable to other assets used by telecommunications operators and explains why they are appropriate.[1]

> *Unlike assets such as the technical equipment and the transmission medium (for example fibre), civil engineering assets (for example ducts, trenches and poles) are assets that are unlikely to be replicated. Technological change and the level of competition and retail demand are not expected to allow alternative operators to deploy a parallel civil engineering infrastructure, at least where the legacy civil engineering infrastructure assets can be reused for deploying an NGA network.*
>
> *In the recommended costing methodology the Regulatory Asset Base (RAB) corresponding to the reusable legacy civil engineering assets is valued at current costs, taking account of … the costs already recovered by the regulated SMP operator. This approach sends efficient market entry signals for build or buy decisions and avoids the risk of a cost over-recovery for reusable legacy civil infra structure. An over-recovery of costs would not be justified to ensure efficient entry and preserve the incentives to invest because the build option is not economically feasible for this asset category.*[2]

12. Under this RAB approach the current cost of the asset must take account of the costs already recovered by the SMP operator and only include the recovery of costs that have not been previously recovered. This method of costing regulated services is used extensively in the UK for almost every other utility, for example water, gas and electricity. In fact the only reason a different approach is used in telecoms is because the regulator is attempting to encourage market entry by new market operators and therefore prices are modelled on a hypothetically efficient operator basis and the incumbent operator's sunk costs are marked back up to the current level a competing operators may incur. Of course, this has the drawback of gifting the incumbent operator excessive returns

[1] Commission Recommendation of 11 September 2013 on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment (2013/466/EU) (NGA costing recommendation")
[2] NGA Costing Recommendation, Recital (34) and (35)

above the level of costs they actually incur, but this is balanced against the potential advantage of encouraging new operators to the market.

13. In the case of PIA products Ofcom is not trying to encourage market entry, Ofcom is not attempting to flood our streets with contractors, diggers and new trenches instead Ofcom is trying to reduce the civil infrastructure costs for competing network operators, increase the efficiency/use of BT's ducts and ultimately enable operators to roll out new network more cost effectively. Therefore, if indeed Ofcom are going to revisit their PIA cost modelling they need to do it properly, paying particular attention to the costing methodologies they should be using and the overall purpose of the level that prices are being set. We will now address BT's suggested approach and evidence.

14. BT Group and Openreach explain that Ofcom's original proposal's that led to, in reality fixed prices for spine duct over the review period were not the optimal proposal because, (a) they would cause pricing instability, (b) Openreach's FTTP deployment has increased utilisation and (c) a 46% weighted average share of duct would be representative of future use.

15. Vodafone finds BT's response, made through Openreach and BT Group astonishing. The high level assumption underpinning their response (and Ofcom's subsequent proposal) is that duct and pole utilisation in the future will be lower than originally expected in January 2020.

16. The entire basis of the market review is to incentivise far greater levels of alternative network build by weakening the price regulation of active services. Alternative network build is further supported by the availability of cost based access to the Openreach duct and pole infrastructure. The proposals now put forward suggest that Ofcom now doubts the levels of alternative network build that will be achieved and increases the costs of the network facilities for the organisations that are trying to assist Ofcom in achieving its vision.

17. Ofcom is proposing that the price of these products increase by over 30% over the review period because they now forecast that the utilisation of Openreach's duct will be less than previously thought. This must have implication for the wider policy aspects of Ofcom's modelling, Vodafone is very aware that Ofcom's calculations that estimated the excessive returns Openreach would enjoy include assumptions regarding future volumes forecasts and their associated unit cost impacts. If PIA use decreases in the future, it follows that the use of Openreach's active products will increase, Ofcom needs to take a holistic approach to future forecasting. Openreach cannot have it both ways, high PIA volume forecast's when active product unit costs are being calculated and then low PIA volume forecasts when PIA prices are being set.

18. One of the arguments put forward by Openreach is that duct utilisation has only increased over the last year (or the main driver of utilisation increases) because of Openreach's roll-out of fibre. Therefore when Openreach take out their copper network over the next five years, their utilisation will reduce and prices, if based on utilization, will rise. This logic appears to completely miss the point that currently Openreach's fibre roll-out is only a fraction of what it is forecast to be in the future. Currently, Openreach's fibre roll-out covers less than 10% of the UK. The Governments latest predictions is that by 2025 fibre roll-out will cover 85% of the UK, with Government providing £5bn of funding, of which Openreach is likely to receive the majority. High utilisation reducing to lower utilisation outcome may occur if Openreach was operating a fibre and copper network in the majority of the UK today, it is not. This is before we take account of the huge additional duct use that will be generated by competing network operators.

19. Another argument put forward by Openreach and discussed by Ofcom is around the future utilisation of the network by other network operators. Openreach suggest an average allocation of 46% representing between two and three operators utilising a duct. This completely ignores the fact that (a) there are two markets, a broadband market and a leased line market with different industry operators both of which will use duct and pole access, and (b) the volume of PIA orders today and the range of operators requesting PIA products from Openreach is extensive.

20. Vodafone agrees with the principle of stable PIA prices, in fact due to the nature of PIA access to underpin long term business cases it is imperative. However, prices need to realistically reflect the correct and appropriate cost base and then also reflect future utilization. PIA is the main regulatory remedy that enables Ofcom to reduce regulation for other products. Increasing prices and not fully considering the wider modelling or market consideration will be damaging. Future forecasts also need to consider that a range of operators, all operating in different markets, using PIA and fibre for a range of different uses will be utilising the products in the future. The simple fact is that the volume of data, internet usage and the range of services delivered over fibre is increasing massively, for Ofcom to use assumptions that forecast just modest use of PIA that assumes all operators offer a complete range of products covering all markets will not be the reality.

21. It has only been since summer 2020 that the full DPA product with SLGs has been available. It is clear that the number of organisations that consider that DPA is finally becoming fit for purpose is increasing. We understand that 90 CPs have now completed Openreach service establishment to use DPA and that Openreach forecast this will rise to 100 by the close of the year. Ofcom has a regular stream of code power requests from new entities wanting to enter the market.

22. We urge Ofcom to continue with stable PIA pricing that has underpinned its widespread take-up since 2018 and instead consider the wider principles and costing approach that should be considered in 2025. We do not believe this would cause any issue for the market because prices, when modelled against actual costs incurred and unrecovered to date would be set at levels lower than they currently are today.

Dark fibre prices set to increase by between 20% and 60%

Question 4.1: Do you agree with our revised proposals relating to dark fibre pricing? Please set out your reasons and supporting evidence for your response

23. Ofcom appears to be proposing that dark fibre prices in 2021 increase by between 20% and 60% compared to the prices proposed in their original January 2020 consultation. This price increase is not due to a modelling error, or indeed a methodology change in terms of the way the prices are calculated. This proposed price increase is related to the fact that Openreach now appear to believe it is now appropriate to move more fibre costs from products that are no longer subject to a cost based charge control into the cost stack of products that are being charge controlled using a cost based approach.

24. Of course, Openreach's proposal is directly in line with their commercial interest and the optimal outcome for them. Higher allocated costs will result in higher prices and therefore higher resultant profits. It is important to note that the increased costs proposed by Openreach are not incrementally incurred costs to deliver dark fibre, they are merely a group of general network costs, of which more are now deemed by Openreach to be appropriate to allocate towards Ethernet/dark fibre services.

25. The amount of detail provided by Ofcom does not enable other operators to make an informed judgement as to whether Openreach's new allocation methods are more or less accurate, however we would make two observations:

- Consistency: Ofcom explain that their approach to PIA utilisation is proposed so as they do not have to rely on actual utilisation in the future because this may led to uncertain prices and therefore Ofcom show a strong preference for consistency and stability. This has historically been a strong theme for Ofcom. Consistency and stability leads to pricing and market stability that leads to market investment and development. Making such a drastic allocation change now, just before setting fibre prices is not in keeping with

Ofcom's general principles and is purely based on using allocation methods that a self-serving Openreach believe to be more reflective of their view of network usage.

- Cable's V's actual number of fibre's: It appears that Spine fibre has been allocated using the volumes of 'cables' used in the distribution network. Cables can include a varying number of fibre's, older cables tend to include fewer fibre's whilst newer cables tend to include more fibre's. The number of fibres used by the distribution network drives the usage of further upstream network fibre in the spine and core network not the number of cables connected. It is likely that newer FTTP cables carry more fibre's and therefore increased volumes of traffic compared to older leased line cables that probably contain fewer fibres as historically was the case.

26. Ofcom also now propose to consult on a range of prices for dark fibre services in contrast to the original January consultation, where they consulted on a single price for each service. Whilst we understand the preference for consulting on a range which enables small price variations without further consultations as a result of stakeholder input, we believe now Ofcom have gone to the other end of the spectrum, seeking to use a huge range of projected outcomes.

27. In the January 2020 consultation Ofcom consulted on a single price for each service, now Ofcom propose to consult on a price range for each service whereby the highest proposed price is over 30% higher than the lowest proposed price. For example the single fibre annual rental price could be £830 in the first year of the control or £1,120. This reduces operators ability to constructively respond to Ofcom's consultation and indeed to plan for future network deployment.

28. Included in Ofcom's January consultation was a table that shows Ofcom's 'Low' and 'High' summary of modelled scenarios (shown below) we assume this is the range of assumptions that were used to produce the range of dark fibre prices. It is assumed that the 'Low' scenario relates to the higher calculated excessive return amount for Openreach (£2,475m) and also the low range of dark fibre

prices.

Table A16.12: Low and high-cost scenario parameters assumed

Parameters	Low	High
WACC	Other UK Telecoms: 6.9% Openreach: 6.1%	Other UK Telecoms: 8.9% Openreach: 8.1%
Efficiency	LL operating costs: 7.0% LL capital costs: 6.0% WLA operating costs: 6.5% WLA capital costs: 5.0%	LL operating costs: 4.0% LL capital costs: 3.0% WLA operating costs: 3.5% WLA capital costs: 1.0%
Volumes	LL: assumed higher exogenous growth, greater demand for higher bandwidth services, no impact of PIA and no impact of Dark Fibre WLA: assumed lower Openreach FTTP and greater impact from alternative networks	LL: assumed lower exogenous growth, greater demand for lower-bandwidth services, high impact of PIA and high impact of Dark Fibre WLA: assumed greater Openreach FTTP and lower impact from alternative networks
Accelerated depreciation	Depreciation after 2030/31 brought forward	Depreciation after 2030/31 brought forward

29. However, the 'Low' scenario does not appear to include all the correct 'low' assumptions. For example, the volume assumption 'Low' includes '*WLA – greater impact from alternative networks*' This assumption would have the impact of increasing Openreach's unit costs and therefore reducing their excessive profits, therefore it is unclear why this selection is included in the 'Low' scenario. It would appear that the 'low scenario' that relates to the calculation of the higher excessive profits and low dark fibre prices is actually a mixture of assumptions, some that would lead to higher profits and higher unit costs for dark fibre and some that would lead to lower profits and lower unit costs for dark fibre. Therefore, we conclude that the calculated higher profitability derived at £2,475m and the lowest unit costs calculated for dark fibre services is not actually the highest calculated profit that Ofcom's model would produce/lowest dark fibre unit costs and therefore not representative of a true high profitability range estimate/low dark fibre unit cost.

30. The table above also does not include the full range of input modelling assumptions and as the paragraph above shows, it is not clear to us , nor other interested stakeholders, precisely what input assumptions Ofcom have used to produce the range of prices for dark fibre services. We would suggest Ofcom provide additional supplementary information that clearly identifies the input assumptions used to produce the range of dark fibre prices so that they can be fully understood by stakeholders. This would allow stakeholders the opportunity to fully engage with the input assumptions and provide further evidence to ensure a robust and accurate conclusion is reached

31. Clearly the migration, and use of Openreach's active and passive products by other operators has an impact on the modelled unit costs of dark fibre services. Other network operators that procure these services should have the opportunity to understand Ofcom's input assumptions and provide additional information and evidence they feel is relevant.

Patch panel and dark fibre product migration

32. A significant part of the dark fibre price change proposed relates to the cost of the patch panel. However, the whole premise of installing a new patch panel with each new dark fibre connection and the resultant assumed utilisation of each patch panels is incorrect.

33. The majority of dark fibre circuits will be circuits that are switched over from existing active Ethernet services. These active Ethernet services will already be using terminating equipment, so no new patch panels will be required. Dark fibre migration will be the primary product required for the installed base with a supplementary new install option being required for brand new fibre installations only.

34. Patch panels where these are needed for entirely new installations can carry a number of fibres. A new panel is simply not needed for each connection.

35. Ofcom need to consider the utilisation of each patch panel and include it in the charge control pricing in a way that incentivises efficient use. For example, a way this could be done is to include the patch panel costs in the rental charge and assume a utilisation rate based on Openreach's actual utilisation rate today. Another way this could be done is to include in the charge control pricing a migration product; which priced lower than the proposed connection charge enables a lower priced connection from an active product to a dark fibre product. This migration charge could exclude patch panel costs acknowledging that the active service the migration is coming from has already included a patch panel.

36. If Ofcom proceeded with its current approach it would not incentivise Openreach's efficient use of equipment and it would enable Openreach to further delay launch. Indeed, in some exchanges installing further patch panels is likely to prove difficult and this could be erroneously cited as a reason to decline to provide dark fibre services in some locations. Vodafone would have raised this issue earlier in the process, but the latest approaches by Openreach and patch panel discussions have only come to light as a result of Ofcom's consultation and the dark fibre industry working group.

Openreach will take 25% of the next 5 year market review to productise DFA

Question 5.1: Do you agree with our revised proposals relating to DFA implementation? Please set out your reasons and supporting evidence for your response.

37. The history of the dark fibre regulatory remedy and Openreach's subsequent productisation of the product is long and extensive. Ofcom imposed DFA nationally in 2016 and Openreach worked with industry to productise the product, although it was not eventually imposed due to an appeal by BT.

38. Dark fibre for exchange backhaul was imposed on Openreach at the end of June 2019. The soft launch and the reference offer followed six weeks later, with the full product available 6 months after that. As another example, when the 2016 dark fibre remedy was withdrawn, Openreach produced a very expensive alternative, the OSA filter connect product. For this product Openreach carried out an industry consultation in October 2017, started the product design process in December 2017 and then produced a full product and launched the product by April 2018.

39. We now have dark fibre available for exchange backhaul, we are only talking about making the dark fibre product available for access services in Area 3, this surely cannot take 15 months. It is of course very difficult for us to comment on precisely why it might take Openreach longer to productise this product but we note that they have invested millions appealing Ofcom's previous decisions and appear very motivated in seeking to delay the implementation of this product. This action to delay is the latest salvo in the campaign to delay and Ofcom must not bow. A reasonably efficient operator should be able to fully productise a new network product in six months (especially taking account of the head start noted above), with Openreach achieving this timescale when it suits their own objectives.

Question 6.1: Do you agree with our proposal that the maximum charge for the SOGEA 40/10 service should be equal equivalent to the maximum MPF charge plus the maximum VULA 40/10 charge? Please set out your reasons and supporting evidence for your response.

40. It is essential that SOGEA pricing at 40/10 is safeguarded. We believe 2020/21 MPF pricing (without CPI indexation) would be the most appropriate benchmark. There is no justification for an annual CPI price increase on copper bearers (WLR or MPF). We would repeat our call for 80/20 services to be included within any GEA/SOGEA pricing anchor. There is clear evidence that 40/10 service will not act to constraint prices above this speed. Ofcom's own evidence indicates that consumers never regress on bandwidth and that the mainstream market is now firmly at 80/20, with bandwidth demand rising year on year. Providing pricing certainty at 80/20 will not discourage fibre build (with the benefits of fibre clearly showcased at speeds in excess of this).

41. There are also very clear concerns around the price of WLR, which is used as a copper bearer to deliver broadband. It is vital that MPF pricing stability is maintained to safeguard broadband pricing, as it makes up a bigger proportion of consumer broadband costs than the GEA element. SOGEA migration for many may not be right solution, as it would involve a double migration (from WLR/GEA to SOGEA and then FTTP). To safeguard the consumer experience, it would be far more efficient to migrate directly from WLR/GEA to FTTP in one-step.