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David Michels, OFCOM

CC: Sharon White

Riverside House, 2A Southwark Bridge Road, London SE1 9HA

Dear Mr. Michels,

We are writing in response to OFCOM's consultation on strengthening Openreach's strategic and operational independence, with reference to the Digital Communications Review. As substantial shareholders in BT, we feel strongly that investor views are taken into account by OFCOM and would seek further engagement on key issues outlined in this letter as part of the consultation process.

About Lansdowne Partners

Founded in 1998, Lansdowne is a UK based Asset Manager that invests approximately £15bn of client funds in equity markets, with a mandate to invest across markets globally. We allocate capital on behalf of some of the world's largest investors including pension funds, endowments and sovereign wealth funds. Our investment approach tends towards concentrated positions, a deep understanding of the businesses we own shares in and a long-term investment horizon, often with holding periods of 5-10 years.

Our Telecom Investments

Our Telecom investments focus on infrastructure owners who have the capital to invest in differentiated networks that can take advantage of what we view as substantial future demand for increased bandwidth. Given the long timeframes involved in infrastructure investment, we have concentrated on markets where companies have a clear incentive to invest and certainty of the regulatory paradigm within which they operate. Our investments in telecom compete for capital both between countries and other sectors of the economy.

Today, we own approximately 2.6% of BT, and 1% of Comcast Corporation in the USA. These investments each represent over £1bn of capital at current market prices and were initiated in 2013 and 2012 respectively. In addition, prior to its takeover by Liberty Global, we had a sizeable holding in Virgin Media.

Lansdowne Input to the Openreach Consultation

Our comments below fit into two sections: first, we felt it useful to explain what we, as private-sector shareholders, believe are the right strategic priorities for BT. In doing this we argue that these priorities are actually very similar to both the objectives outlined by OFCOM and long-term consumer demands. Although lost somewhat in current rhetoric dominated by the company's competitors, this alignment perhaps should not be a huge surprise: looking to fulfil consumer needs being the most logical starting-point for any commercial organization.

We then go on to discuss our concerns with the current proposals. As detailed below our basic belief is that the uncertainty that such proposals will create will materially raise the cost of equity required by investors such as ourselves to fund infrastructure investments. By doing this these proposals will raise prices for consumers, reduce investment and raise associated funding costs be it for the pension scheme or alternate infrastructure providers. This outcome seems to us explicitly what OFCOM seeks to avoid in describing 'disproportionate costs' from a review, yet is in our minds an inevitable consequence of what is suggested.

Lansdowne's view of appropriate BT strategic goals

BT has three interrelated attractions to us as investors. First, consumer demand for its core product, data bandwidth, is rising. Second, as a consequence of this, companies such as BT and Virgin that have consumer brands built on infrastructure provision, should be able to gain greater consumer loyalty in the broader multimedia market, hitherto dominated by businesses founded purely on price or content-driven propositions. Finally, the creation of broadband networks is an industry characterized by rapid technology change, offering opportunity for R&D returns to a business with BT's heritage and IP. Such returns are potentially twofold, first in ensuring their own capex is optimally deployed but secondly in creating a real value-stream in exporting this R&D on a more global basis.

Given these priorities we have constantly urged the company to push aggressively on network innovation, even at points where its general financial position was far from robust. To our minds this was not just an optimal economic outcome but an essential one, as without a superior network the very existence of the company is far from a given. As noted above the logic for this was threefold, we were confident returns on the investment itself would be strong given evolving consumer needs, we felt that association with a strong network would provide a clear boost to the retail brand and we felt that being at the forefront of network design would embed an R&D process that would have global value.

The goals noted in previous paragraphs seem to us ones which remain the right ones for the foreseeable future and close to the consumer and OFCOM's natural desired outputs. Encouragingly, regulation over the last decade has allowed this alignment to be manifest, something that has driven an infrastructure that has underpinned the UK's emergence as a leading e-commerce economy. In doing this not only have BT investors been rewarded for risk being taken but alternate business-models, including infrastructure-competition, have been attractive to us and other investors.

Moreover, where the strategy has been less well-implemented we believe that regulators, shareholders and customers are much more closely aligned than might be imagined. Like you, we have been frustrated by the inability of the company to deliver consumer-service metrics to the level we think should be viable given the infrastructure investments made. This frustration is economically-driven; as Virgin have shown the opportunity to boost consumer branding through strong network performance is a very real one that BT have yet to optimize. We have discussed this regularly with senior management and believe that they are now alert to this economic incentive in a way that may not historically have been universally the case. We are pleased that OFCOM measures continue to reinforce strong service requirements to consumers and downstream customers of Openreach but, frankly, feel that if management do not deliver improved consumer-service shareholders such as ourselves should also act decisively to prevent it persisting. In addition, despite not always with a favourable outcome for BT we feel OFCOM have proven effective at safeguarding competition between retail operators in deploying tools such as the Margin Squeeze Test, which have contributed to a vibrant market.

In summary, our view of the company is very simple. We wish it to provide the products consumers wish to buy, at a price they can afford given sensible capital commitments, with service at a level that generates a strong consumer brand. Such objectives to us are very closely aligned to other stakeholders and viable given the company's tangible and intangible asset base. As such we are happy providing capital to the company to do this aggressively, but recognize that such capital provision needs us to hold management clearly to account if it is to be optimized.

Current OFCOM proposals in this context

In the context of this strong starting-point of alignment between regulator, consumer and shareholder we are somewhat unnerved by current proposals. Our concerns are twofold: first, we believe that the emphasis on separation between retail and network ownership has downsides not properly highlighted given the more vocal approaches of BT's asset-light competitors. Secondly, the compromise corporate structure proposed is one that we feel may well combine the negatives of both extreme views and will materially raise the cost of capital required by investors such as ourselves, inevitably leading ultimately to increased prices for consumers and reduced infrastructure investment.

While we understand the theoretical attractions of separation between network investment and consumer-service provision we feel that practically two major benefits will be lost to the ecosystem should this be taken further. First, as noted above, the consumer's association of retail brands with network quality is an enormous commercial incentive for the network operator to continue to raise performance standards. As noted above we would not argue BT have done this as well as they should but can see clearly its potential in Virgin's consumer offer. Taking away this incentive by separating the brands would take pressure off the network operator from the consumer, something that does not feel in anyone's interest.

Secondly, the retail customer underpinning the network infrastructure has, we believe, forced the network investment to be optimized commercially. This has two benefits, ensuring costs of infrastructure are controlled in a manner the customer can afford and also forcing the R&D department to truly innovate creating an IP value that has global potential. This potential has been evident in the G.Fast innovation where BT is both materially improving cost/benefit economics to the consumer but also creating an IP set that is likely to be replicated elsewhere in the world (and a large part of Deutsche Telekom's desire to take a stake in the company).

Without this direct sanction we would be very concerned that the incentive of the network operator would revert to that seen in other regulated utilities, namely maximize allowable capital expenditure. Such an outcome would create very difficult regulatory bureaucracy, likely lead to a misallocation of capital that would raise consumer prices over time and certainly militate against the creation of IP that had relevance in overseas commercial markets.

Independent of the value of separation, however, we believe that the current structure advocated has real issues for capital providers. ***As stated, it appears that shareholders would be expected to fund a business over which they had limited operational control or direct oversight, a structure we have never seen in any other industry or country. This notion of an untried corporate structure with questionable corporate governance is one that forces equity investors at best to require a higher return on capital to compensate for the materially higher risk profile***. Such an outcome, in turn, will have two negative consequences in the real world, less investment as shareholders demand caution from BT group and higher prices for consumers. Arguably this is actually the best-case outcome of such an untried structure. Indeed it is far from clear that we could actually invest at all in such a structure given our own fiduciary duties for our clients. We can see no way, for instance, that such a structure would be compliant with the UK Corporate Governance Code.

We would note also that the impact of such a move would not just raise the required return on capital for Openreach, but also for competitive infrastructure-providers and other regulated entities in the UK. We could not viably invest in a rival infrastructure business while the incumbent had such unclear outcomes unless the price umbrella set were so generous as to give us a margin of safety. Meanwhile investments we would consider in other regulated entities outside the Telecom space would now have to compensate us for the risk of the precedent of operational control being withdrawn, again raising the costs for funding other investments and prices for consumers. For this to be initiated at a point where attracting investment into the UK is so important seems also especially risky.

You rightly cite in your document the need to avoid unnecessary costs in prioritising separation and are explicit in concern about the effect on funding of the pension fund from a 'riskier' business structure. In this context, we are really surprised that the more dramatic impact on funding costs (from rising returns required by actual investors) seems not to have been highlighted. We believe that this cost would move materially more based on current proposals (as it should being a real operational one) than any pension-fund effect and, being the direct cost of funding infrastructure, have real consequences for prices and investment at odds with OFCOM's stated overall goals. While understanding the balances any regulator needs to strike, we feel that the failure of the current document (or consultation) to address this is a dangerous omission and hope our notes here go some way to remedy this.

To end this submission we should reiterate our initial comments. Alignment between regulators, shareholders and consumers is real, and made more real by network operators being exposed to consumer choice through their retail business. OFCOM has, in the last decade, enabled this alignment to be manifest with great results for the consumer and broader UK economy. Current proposals, unfortunately, risk this unwinding by creating a lack of alignment and higher uncertainty that can only lead to higher costs of capital, less investment and higher prices. We strongly urge that this impact is minimized and the current consultation is a real one that includes the funders of the business as well as the businesses themselves. To that effect, we would be very keen to enlarge upon our views and discuss OFCOM priorities more fully in person and are always available should you wish to discuss the above or anything else.

Warm regards,

Peter Davies and Jonathon Regis

FUND MANAGERS, LANSDOWNE PARTNERS