

**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**

Introduction and Summary

Ofcom faces a challenge in implementing legislation that looks increasingly anachronistic in the face of the Government's ambition to have nationwide coverage of gigabit-capable connectivity by 2025, and the public funding of broadband provision to harder to reach areas.

We understand Ofcom's desire to limit the amount of its investment in work that may be wasted because no claim is made for recompense from an industry fund. Indeed, we believe this is the likely outcome because the circumstances are likely to mean that the net cost incurred will not constitute an unfair burden for BT¹. Nevertheless, we believe that there are more specifics that could be added to the guidance to the benefit of both potential claimants and contributors; we list our suggestions below before answering Ofcom's specific questions.

- Ofcom is clear that it expects no more than one claim per annum. However, it is not entirely clear how *rejected* claims will be treated in any subsequent claims. Ofcom says in 6.10 “[w]here 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 [sic] up to that point (i.e. because it was not previously deemed unfair for the Universal Service Provider to bear those costs).” However, Ofcom does not specify when previous determinations would be relevant. In contrast, it says in 4.20 that “we expect only in exceptional circumstances would we commence a review that materially covers the scope of one or more previous reviews” (our emphasis). It might be better if Ofcom could be definitive that a Universal Service Provider (USP) *cannot* resubmit a previously rejected claim aggregated into a (presumably) larger subsequent claim. This would encourage the USP to delay claims (and avoid speculative claims) until it is convinced they constitute an unfair burden.² We suggest that it is probably better for all concerned if BT is encouraged only to make a single claim for recompense from a fund once a lot more is known about: demand, efficient cost of supply, upsell etc. This would go a long way to obviate concerns on the part of claimants and contributors about under or over recovery of the net cost of the USO.
- Ofcom is sceptical that BT will enjoy material intangible benefits from being a Universal Service Provider: “we do not expect these benefits to be significant given

¹ We use BT and USP interchangeably in this response; it is unlikely that KCOM will make a claim on an industry fund given its plans to deliver FTTP to all premises in the Hull area (2.11).

² However, if Ofcom declines to commence a review (rather than rejects a claim), the USP should be allowed to roll-up its net costs into a future request for an assessment.

the expected small size of the broadband USO and in the light of the fact that BT and KCOM are already designated as Universal Service Providers for the telephony USO.” [9.24]. We suggest that Ofcom has been too hasty to underplay these benefits; indeed, these may particularly relevant for the assessment of an unfair burden *given the expected small size of the broadband USO*. We note that alongside its recent re-branding, BT has sought to position itself as a “*national champion and doer of public good*”³ – being a USP is obviously consistent with this objective and we might expect the consequent market benefits to be meaningful, even if the demand is relatively low, because each new connection is a potential good news story to be celebrated through BT’s communications channels. Ofcom could give more detail on how *it* would go about estimating the market benefit of being a USP. This would give BT a better indication of the quantum of efficiently incurred (avoidable) cost that it would need to bear before contemplating making a claim.

- Moreover, the calculation of benefits would likely be a single national figure (as it is at the moment) because it is hard to see how this can be easily disaggregated for a patchwork of geographic claims. This again suggests that BT would better off waiting until it believes that the bulk of requests under its USO obligation have been exhausted before submitting a claim. Paragraph 5.3 contemplates that BT should assess the level of “*indirect benefits that the Universal Service Provider derives from being designated*”. However, we do see benefit in BT understanding how Ofcom would go about making this calculation (since it is expected to include an estimate in the information supplied to Ofcom) – especially since we argue above that BT should not be allowed to go back and ‘relitigate’ previously rejected claims on the fund.
- We note that in paragraph 3.20 Ofcom stresses that it “*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*” and that the rules should not “*give rise to, any undue discrimination against particular communications providers or particular Universal Service Providers*”. We agree, moreover it is difficult to understand why, for example, mobile providers should be excluded from the industry fund. Their inclusion will help to minimise market distortion and the incremental externality benefits from additional USO connections (via network effects) to both fixed and mobile providers should be similar (albeit negligibly low in both instances)⁴. As Ofcom says in 3.25, the principle of non-discrimination requires that “*similar situations must not be treated differently*”.
- Ofcom notes in 3.15 that 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. It explained that the unfair burden is a burden which, for each undertaking concerned,

³ For example, see: <https://www.mobileeurope.co.uk/press-wire/bt-appoints-itself-national-champion-announces-halo-converged-offerings>

⁴ Arguably OTT providers benefit most from the USO.

“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.” Therefore, we suggest, there is an acceptance that the act of being a USP can legitimately fall outside of *“normal commercial expectations”* [6.6] i.e., it is a service provided at a loss to the USP. Ofcom helpfully states that the Universal Service Directive excludes *“the possibility that any net cost automatically gives rise to a right to compensation”* (our emphasis).

- We therefore suggest that the test of unfairness is initially a test of an organisation’s ability to pay (“bear”) relative to its cash generating ability. Goldman Sachs estimates that BT should have pre-pension cashflow of £2.2 billion in 2021⁵. The existing guidance seems indifferent as to whether the USP has any *“control over the universal service conditions that it faces”* [6.9]. It is only if the cost of funding the USO is *prima facie* unfair that the question of whether BT could make up the burden elsewhere through the exercise of market power becomes relevant. This obviously would require some analysis but, on the face of it, the continued existence of market power at the wholesale local access market and the imposition of only ‘fair and reasonable’ pricing requirements on wholesale products with speeds above 40/10 would give BT ample scope to recover any efficiently occurred unfair burden.
- As a scalar comparator we have considered Ofcom’s previous proposal that BT should reduce the bills of its landline only customers by between £5-7 per month (<https://www.ofcom.org.uk/about-ofcom/latest/media/media-releases/2018/bills-cut-for-bt-landline-only-customers>). BT agreed to this proposal. The press release reports *“a saving of £84 a year, or 37%, for up to one million of BT’s landline-only customers”*. In other words, this proposed intervention would cost BT up to £84 million *per annum*⁶. We accept that this is an imperfect comparison with the USO. In this instance, Ofcom had a strong claim that it was stripping out excess profits; in contrast, the funding of the USO is about bearing anticipated losses. However, we do note the difference between an intervention that will end up costing BT hundreds of millions of pounds (ignoring its ability to make this up through market power exercised elsewhere) and a USO which is expected to cost BT *“tens of millions”*⁷.
- Ofcom should consider whether it is appropriate to have a ‘pay and play’ element to the industry funding of an unfair burden. Put another way, non-USPs should get a discount on their contribution if they can show that their own investment has reduced the scale of the USO. See paragraph 9.2 *“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 USO.”*

⁵ Goldman Sachs note 6 November 2019.

⁶ The NPV of the cost would of course be much higher – hundreds of millions – despite the decline in landline only customers over time.

⁷ See slide 5 from BT’s trading update on 5 August.

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?

In principle, yes. The onus should be on BT to submit a complete set of information and for Ofcom to assess whether it is worthwhile to commence a review. There should be no obligation on Ofcom to commence a review.

As noted above, we do however detect a slight inconsistency between the paragraphs on finality (4.17 – 4.21) and paragraph 6.10. In the latter there seems to be more scope for BT to count again net costs (that have previously been rejected) in a subsequent claim from the fund. This would undermine the principle of finality (for all parties) espoused in section 4 and weaken the (appropriate) incentive for BT to submit a very limited number of claims for recompense.

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?

We believe that this is a comprehensive list.

Pages 10-11 of the recent Connected Nations Report list the various publicly funded schemes to improve broadband coverage. A shortcoming of the USO arrangements is that these schemes will effectively be ignored if their delivery date for the customer is more than 12 months after a request for a USO connection. That said, we support Ofcom's recognition in 5.10 a) that future costs can "*be avoided in complying with the universal service conditions*" (see also 9.21). Ofcom should ensure that these (capital) costs are removed from the net cost calculation and we would welcome clarity on how it intends to treat these avoided costs. An industry fund must not be used to reduce the quantum of public funding for schemes with a higher specification (see also below).

The above is particularly because clawback (aka BDUK gainshare provision) stands at £667m on BT's books. This is funding that can be recycled into super-fast broadband provision by local authorities; the large proportion of which will be supplied by Openreach. In the meantime, the provision of the USO could reduce the extent of gap funding required.

However, the issue of avoided costs is not followed through into the draft funding regulations. Paragraph 3 (2)(a) talks only of “costs that would have been avoided had the relevant universal service conditions not been imposed” rather than costs that are avoided because of the USO.

Ofcom says that it would decide about an audit on a case-by-case basis. We suggest that any net cost that is judged to be an unfair burden on a USP should be audited by an independent party (at the USP’s cost).

We said in our response to the previous USO consultation (Delivering the Broadband Universal Service - Proposals for designating providers and applying conditions): “...if a USP provides a USO connection using an inefficient or ‘gold plated’ technology then no part of its net cost should be claimed from the fund. There must be no ex post adjustment to assess what the net cost would have been had the most appropriate technology been deployed, with the latter included in the industry fund. This gives the USPs the right incentives to deploy their (and potentially others’) capital judiciously. We understand that this accords with Ofcom’s views in (for example) 7.37: “we would only compensate a net cost where it can be demonstrated that the costs incurred in providing connections were efficient”.

Ofcom rejected our suggestion and in paragraph 5.14 it says that it would “make appropriate adjustments to the net cost” if it determines some costs had not been “efficiently or necessarily incurred”.

However, we remain concerned that BT may gold-plate its USO obligation to be consistent with its ‘full fibre’ ambitions and that Ofcom may have encouraged this by saying in its previous statement that “we consider that FTTP is likely to be an efficient technology choice for delivering USO connections to the majority of USO premises”⁸. We would like to understand how potential contributors to an industry fund can be reassured that the most efficient technology has been used to meet the USO obligation.

We reiterate the view expressed in our previous response⁹ that BT, on receiving a request, must check whether there is a satellite service available that meets the criteria of the USO service. If there is, Ofcom must not include any portion of the costs incurred in the assessment of net cost.

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

In our comments above we suggest that this is best thought of as a two-stage process. First, is the net cost *prima facie* unfair in light of the USP’s ability to fund it e.g., relative to the

⁸ Delivering the Broadband Universal Service Statement: Designating Universal Service Providers and setting conditions June 2019 paragraph 6.21.

⁹ We said: “The envisioned checking process requires that the Universal Service Provider (USP) ensures whether the premises making the request already has access to decent, affordable broadband. This process must include an assessment of whether a satellite service can meet the USO criteria because it is plausible that, in time, a satellite service will meet the USO criteria.”

profit/cash that it generates. Second, if yes, does the USP enjoy sufficient market power to enable it to defray sufficiently the net cost incurred? In this respect we would welcome clarity on what Ofcom deems to be “*relevant markets*” for the purpose of assessing market power / competition (see the draft funding regulations paragraph 5 (2) (a)).

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?

In 7.4(a) Ofcom says that “*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*” (our emphasis). For the avoidance of doubt Ofcom should make it clear that it expects BT to be a contributor to the industry fund (see also our comment below).

In 7.5 Ofcom says that “*the draft funding regulations provide that where it appears to Ofcom that public funds may be used [to pay for the USO], the calculation of any amount to be collected from an industry fund will be postponed.*” We support this position, and it chimes with our view that BT should be encouraged to make an ex post claim for funding once the many uncertainties have been resolved.

We support Ofcom’s apparent bias in favour of a “*wider pool of contributors*” including ‘over the top’ services. This will minimise any distortions. Moreover, there seems no credible case that one class of operators (mobile versus fixed) benefits materially more than another by the presence of the USO.

In the discussion on the calculation of contributions Ofcom proposing allowing “*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*”. However, it is not clear whether Ofcom considers Openreach to be a contributor to the fund (see below). In any case, we think that Ofcom should be clear that TV revenue should be excluded from the assessment of relevant turnover.

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?

We had assumed that BT would be required to contribute towards the net cost of providing the USO (see above) and the relevant question is whether shouldering the whole cost would

constitute and unfair burden. This appears to jar with Ofcom's statement in 8.10 where there seems to be some discretion involved: "[w]here the Universal Service Provider is required to share a proportion of an unfair cost burden, we would deduct the Universal Service Provider's contribution from an unfair net cost". We would appreciate some more clarity from Ofcom. Under what circumstances would the USP *not* be required to share a proportion of the unfair burden? How would Ofcom determine the proportion to be shared?

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

See our comments above on the draft funding statement in answer to questions above. In addition, we suggest that 5 (2) includes the wording from the European Court of Justice and referenced in 3.15 in the consultation. More specifically, included in the 'relevant matters' of whether a financial burden is unfair is whether it 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*".

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?

We agree with the counterfactual, but argue that other non-USPs should be given the opportunity to evidence that their own network build has reduced the net cost of the USO and that this contribution should be netted off against any contribution to the fund. This will mitigate the concern about double-counting expressed in 7.39.

We support the NPV approach to calculating the net cost of providing the USO and the sentiment that this will "*avoid the need for multiple calculations over the lifetime of the asset*" (9.12).

We agree with the financial reporting requirements.