# Vodafone response to Ofcom's Wholesale Fixed Telecoms Market Review

## Pricing wholesale local access services in Geographic Area 3 with a BT Commitment to deploy a fibre network

September 2020

# Contents

# Executive summary

## Regulatory Retreat

Ofcom's decision to accept Openreach's offer amounts to a near complete retreat from regulation for UK consumers. In accepting this deal, Ofcom would disengage from any meaningful role in price regulation for these consumers for five years. With Openreach the only access network available, it would leave a third of UK consumers at the mercy of Openreach's profit maximising pricing strategy. Ofcom's future role would be reduced to that of an observer.

Area 3 covers over 9 million premises. While around a third of premises may receive an upgrade to fibre, and state aid may be used to fund fibre for a further proportion, between 3 – 5 million premises will face the unpalatable prospect of paying considerably more for their existing broadband - a service delivered over legacy copper - with no prospect of fibre on the horizon.

## Excess Profits & Chronic underinvestment

The consultation does not mention that in the last five years, many of these consumers have helped fund a staggering £3.5 billion in Openreach excess profits in the Fixed Access Markets and Wholesale Broadband Access (WBA) Market A[1]. These excess profits should be used to help fund Openreach's fibre rollout. Instead, Ofcom has chosen to disregard these massive excess profits from its consideration of this deal, and instead agree to an arrangement that will see copper broadband users pay for fibre rollout through increased prices. Ofcom is choosing to overlook the fact that none of these prior years of excess profits translated into material network investment, with the ability to generate excess profits actually deterring investment in fibre. Openreach is not being held to account, even when they have publically acknowledged[2] underinvestment in their network.

## Exaggerated claims of investment risk

Ofcom also seems unwilling to challenge Openreach's claims of the apparent investment risks involved in replacing a monopoly copper network with a monopoly fibre one, despite the fact that Openreach has made these erroneous claims in the past. To their considerably benefit, Openreach exaggerated the risks on their FTTC investments, submitting unduly pessimistic business plans for BDUK funding that turned out to be wide of the mark. With BDUK, a clawback mechanism existed to help balance things out and it is predicted that Openreach will have to pay back over a third of the funding received. There is no such mechanism proposed by Ofcom today to refund consumers. In these circumstances, exaggerating investment risk appears a

[1] See Report by Frontier Economics (page 8)

[2] https://www.telegraph.co.uk/business/2017/02/01/openreach-chairman-says-bt-should-have-invested-better-broadband/

worthwhile strategy, with BT shareholders expected to reap the rewards from both state aid and an extensive regulatory holiday.

### Ofcom's affordability review blind-spot

The approach Ofcom is taking here is clearly at odds with its own forthcoming broadband affordability review. The Ofcom WFTMR and the Ofcom affordability review appear to be recklessly disconnected. Determining wholesale broadband pricing from 2021 to 2026 is the single biggest point of influence Ofcom has over the retail broadband prices paid by UK consumers. This all comes at a time when broadband has never been so valued and consumer finances are under an extraordinary amount of strain.

### Consumer harm on Ofcom's watch

An Ofcom decision to step back and allow Openreach to set the vast majority of prices and permit five successive years of +CPI price rises, even on the most basic legacy copper products, would be nothing short of astonishing, particularly as the underlying costs to Openreach of delivering these legacy copper services are likely to fall.

Overall, Ofcom proposals will gift Openreach a further £3.4BN in excess profits, paid for by UK consumers who will be left paying considerably more for their broadband for a prolonged period while having absolutely no say in the deal.

### A bad deal for UK Consumers

In Ofcom's enthusiasm for fibre, it has lost sight of the costs it is inflicting on UK consumers. It has ignored Openreach's massive historic profitability and its chronic under-investment, as well as accepted Openreach's exaggerated claims of investment risk that do not stand up to any level of reasonable scrutiny. Delivering fibre is important and Ofcom is able to put in place a regulatory regime which allows it to meet the primary objective of fibre roll out at least at the level of Openreach's offer while protecting customers from excessive prices.

For a regulator to withdraw from regulation based on a non-binding two-page letter from Openreach, that is neither backed up by a legally binding obligation nor supported by a detailed business plan, would not be acceptable to Ofgem or Ofwat. Why does Ofcom think it is safe to proceed on this basis, particularly at a time when there is renewed speculation over BT's future ownership?

From an administrative perspective, the Openreach letter is not an appropriate basis for the decision Ofcom proposes to make as there is a material risk of Ofcom's fettering its discretion in relation to the period after 2026. Ofcom's approach to this issue appears unlawful.

For the sake of UK consumers, Ofcom needs to urgently rethink its approach, putting forward proposals which both better protect customers and deliver more (and more certain) fibre roll-out by providing realistic and fair incentives for Openreach, rather than a future where Openreach is left to call the shots.

In this response we will show:

- Why we believe Ofcom should carry out **a full impact assessment** of these latest proposals. Ofcom has been a strong advocate of impact assessments in the past and have on a number of occasions linked them directly with **better policymaking**.
- Ofcom have not considered that **Openreach have the ability to roll out fibre to 3.2million homes in Area 3 even without Ofcom withdrawing regulation,** because it is economically viable for them to do so.
- The offer reduces Openreach's incentives to invest in fibre beyond the 3.2 million premises. Why would Openreach invest further when Ofcom have left the remaining copper so lucrative, allowing them to **continue to extract significant shareholder value by withholding investment** in areas where it remains a monopoly. This allows returns in excess of its cost of capital to be earned and further encouragement to await the arrival of state aid to eventually fund the fibre needed to serve the millions of consumers remaining on copper.
- There are **other regulatory approaches that would be more aligned to incentivising investment whilst protecting consumers**. RAB approaches in other industries have been successful at ensuring wider policy objectives are met while constraining returns.
- In mirroring Area 2 regulation in Area 3, the shortfalls of this approach in Area 2 and now in Area 3 are exacerbated. In Area 3 there is not even the prospect of access network competition emerging. The excessive returns Ofcom calculated for wholesale broadband services in Area 2 are based on an incorrect counterfactual and implausible assumptions. **Ofcom's regulatory approach is likely to lead to consumers paying around £3.2bn more** across both markets than they would have under a traditional cost based regulatory approach.
- Taking regulation away from 80/20 FTTC services in Area 3 **where Openreach has and will continue to have a monopoly will be detriment to consumers** and mean that they are not protected from price rises to 'standard' speed broadband services.
- 80/20 is now the volume broadband product and in clear near need of charge control protection. There is compelling evidence to suggest that the 40/10 service is not a constraint on the price of 80/20.

- Price safeguarding of WLR continues to be required. It performs an identical copper bearer role to MPF and should be regulated on similar terms to avoid retail market distortion.

This submission is accompanied by two detailed reports. For the first report we asked Frontier Economics to review Ofcom's revised proposal to accept Openreach's offer for Area 3, contrasting the Openreach offer with the alternative approaches presented in the January consultation. We also asked Frontier to consider the impact on prices, profitability, consumers and the expected level of fibre investment that would occur if Ofcom had not sought to allow Openreach to raise legacy copper prices by +CPI from April 2021.

For the second report we asked SPC Networks, to independently analyse demand for services based on GEA 80/20 and GEA 40/10, examining the relationships between the two services. The report seeks to understand if GEA 40/10 would be an effective anchor of 80/20 pricing. The modelling used to support this report was collated from more than one broadband retailer, and for reasons of commercial confidentiality, Vodafone has not viewed the unredacted report. SPC Networks will supply this report directly to Ofcom.

# Why is Openreach now setting regulatory policy?

1. In the January 2020 consultation Ofcom suggested Openreach could earn excess returns of between **£615m and £2,475m** through the period of the next review, with a central estimate of **approximately £1.5bn excessive returns** (i.e. returns over and above the standard regulated returns). We responded to this consultation in May.[3]

2. In Area 3 according to Ofcom's January 2020 calculations Openreach's excessive returns were limited to leased line/exchange backhaul services due to the proposal of a **cost based charge control** being imposed on all speeds of FTTC in Area 3 in the absence of fibre roll out.

3. However, Ofcom also proposed that Openreach could effectively increase the wholesale prices of FTTC products if they were to invest in fibre in Area 3. Ofcom proposed two options for how this system would work; the first method involved **Openreach making a commitment prior to April 2021** to roll out Fibre in Area 3, the second method involved O**penreach submitting actual fibre roll-out figures for Area 3 each year to Ofcom** and Ofcom adjusting the charge control pricing depending on the extent of Openreach's fibre roll-out in Area 3.

4. In both of the options for Area 3 in the January 2020 consultation **Ofcom proposed to use a precise calculation based on the actual (or planned**) number of premises Openreach rolled out fibre to and adjust the wholesale FTTC and anchor FTTP price BT's retail divisions and other retail operators

[3] https://www.ofcom.org.uk/__data/assets/pdf_file/0024/199230/vodafone-part-3.pdf

would pay. If correctly implemented, such an approach should result in cost based prices over time, albeit with most customers beginning to contribute to the cost of fibre roll out in advance of fibre networks being available to them

5. It now appears that Openreach have, in a letter suggested **a third option for wholesale price regulation in Area 3**. This option involves **no pricing calculation, no cost modelling, and no regulation of any wholesale FTTC prices for speeds above 40/10**. Openreach's proposal simply suggests that wholesale prices in Area 3 should match the level of wholesale prices in Area 2 and in return, Openreach may at some stage over the next five years rollout fibre to 3.2million homes in Area 3 with no clarity on roll out for the remaining 6 million homes in Area 3 and no regulation of fibre prices after copper switch off. This represents poor value for money with Openreach earning large excess profits up front for a minimal roll out commitment.

6. In their original consultation Ofcom included a number of assumptions in their modelling of FTTC prices for Area 3 that we believed to have **highly favoured Openreach and led to the calculation of higher wholesale prices than may otherwise have been calculated**. For example, the calculations of Openreach's market share were low and assumed Openreach would lose significant market share over the review period (based on unrealistic assumptions about the rate of rivals roll out) which unsurprisingly increased the calculated unit costs. Legacy copper assets were written off early and their costs included in FTTC wholesale prices, and the scrap value of copper included which would benefit Openreach was minimal.

7. In this further consultation relating to Area 3, Ofcom recognise the issues with some of their precise modelling in their initial consultation and **take a more approximate 'in the round' approach** to arrive at the conclusion that Openreach's proposal will most probably only lead to further excessive returns (over and above the £615m-£2,475m – central estimate £1.5bn already identified) **of about £313m although they could be considerably higher**. [4]

8. In arriving at the 'most probable' £313m in additional excessive returns Ofcom use a number of high level modelling assumptions which **appear pragmatically to favour a result of lower overall returns. This culminates in Ofcom arriving at a counterfactual to compare Openreach's proposal against that is incorrect**. For example, in the January 2020 consultation Ofcom presented the cost per premise to rollout fibre. Identifying that depending on where the fibre is being rolled out, the cost will vary considerably and in the most rural places, the costs will increase considerably. In Area 3 Ofcom estimate the most economical 3 million homes will cost between £500 - £650 to rollout to,

[4] Figure 3.1, https://www.ofcom.org.uk/__data/assets/pdf_file/0030/199155/consultation-bt-commitment-area-3-fibre-network.pdf

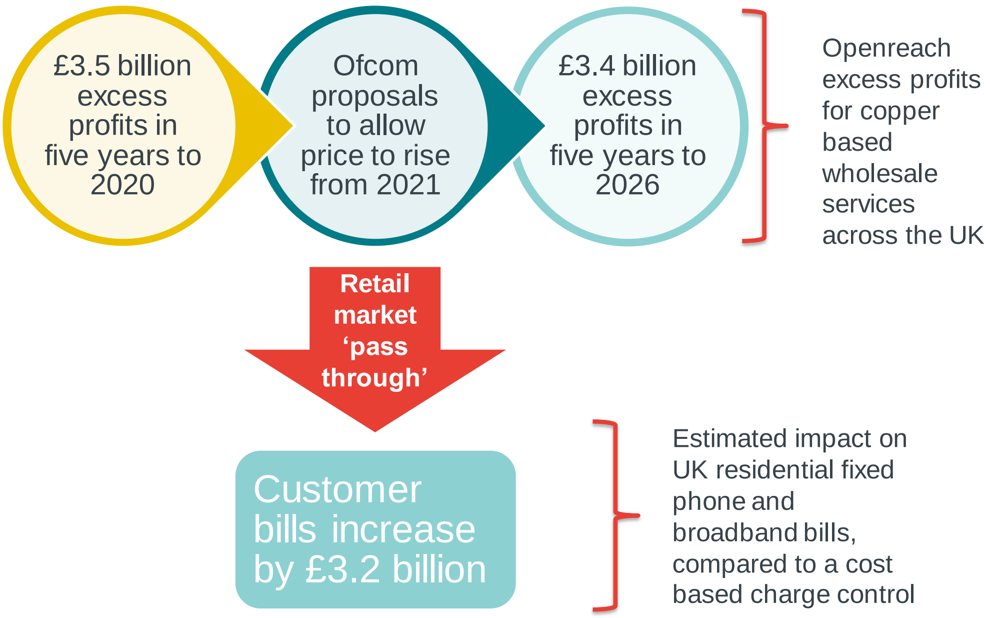
compared to between £750 - £2,000 for the most expensive, deep rural homes. However, Ofcom then use an 'average cost per premise' figure in their excessive returns calculation. Instead of making **the logical assumption that Openreach will rollout fibre in Area 3 to the 3.2 million premises where is it most economically viable to do so, ie the lowest cost to serve premises in Area 3.**

9. **Ofcom have given time and consideration to the advantages gained if they accept Openreach's** offer and allow Openreach to increase wholesale prices in Area 3. However, Ofcom have given no consideration to who will be paying the increased wholesale prices, effectively who will be losing out because of Openreach's excessive profits. The reality is that **end retail consumers in Area 3, some of whom receive the poorest performing broadband in the country will be paying.**

10. The table below[5] shows that Ofcom's **proposals from 2021 over the preceding five years will generate £3.4BN of excessive profits for Openreach** of which £3.2BN will be generated from consumers paying higher prices for their retail broadband, the other £0.2BN will be generated by retail operators paying higher wholesale prices (but not passing them on to consumers)

11. **Openreach have already generated £3.5BN in excessive profits from broadband services over the past five years** but while these profits have been reducing in recent years, Ofcom's proposals will again set Openreach's excessive profits on an upward trend.

[5] Taken from Annex A; Frontier report




12. In our first consultation response we asked the following questions regarding Ofcom's RAB approach in Area 3[6]:

- **Does this RAB model protect consumers from excessively high fibre prices?**
- **Does this RAB model provide incentives for Openreach to invest in fibre?**
- **Does this RAB model ultimately support fibre investment in Area 3?**

13. It is now even more important that Ofcom answer these questions. **Openreach's suggested regulatory approach in Area 3 does not appear to be a RAB approach,** consumers will, as a result of Openreach's proposal pay more for their broadband and the proposal appears to deter alternative providers from building network in Area 3. A regulatory approach or proposal for Area 3 should incentivise Openreach to maximise fibre roll out where this is viable (ie the returns justify the investment).

14. We strongly believe that the proposed regulatory approach from Openreach does not provide any **incentive for them to rollout additional fibre in Area 3,** even where this investment would earn a return

[6] Paragraph 12.19, https://www.ofcom.org.uk/__data/assets/pdf_file/0024/199230/vodafone-part-3.pdf

sufficient to compensate investors for any risks incurred**. It simply enables Openreach to increase their excessive profits** generated in Area 3 from fibre and copper based product consumers.

# The Frontier Report

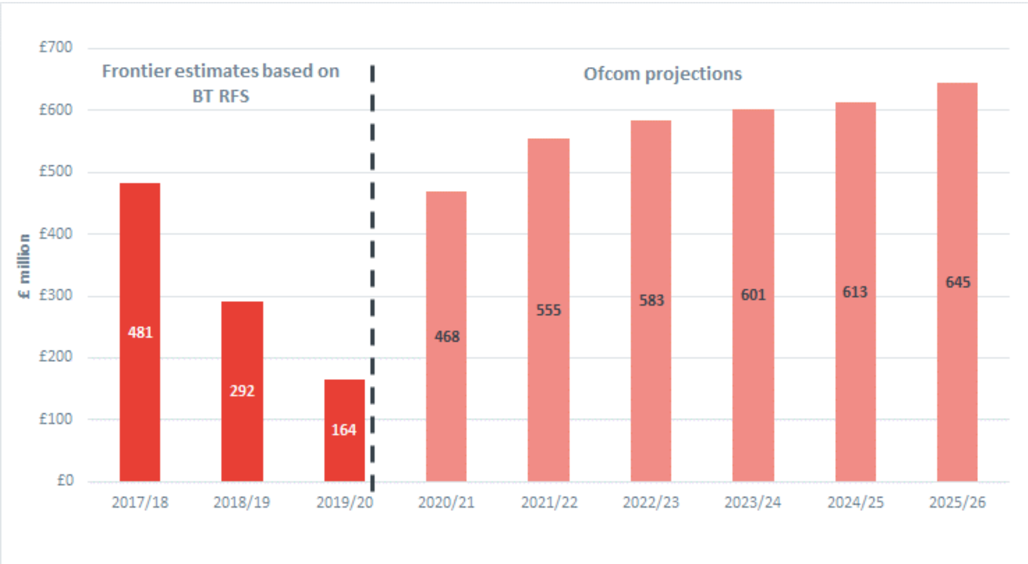
15. We asked Frontier Economics to review Ofcom's revised proposal to accept Openreach's offer for Area 3, contrasting that with the alternative approaches presented in the January consultation. We also asked Frontier to consider the overall impact on prices, profitability, consumers and the expected level of fibre investment that would occur if Ofcom had not sought to allow Openreach to raise legacy copper prices by +CPI from April 2021 across both Area 2 and Area 3.

16. The Frontier report is attached as Annex A. We would draw Ofcom's attention to the following key findings:

- Ofcom has **not conducted a robust analysis** to the degree to which its proposals adequately balance the costs of its proposals in terms of higher prices for consumers, and the benefits of its proposals in terms of increased fibre investment. Had it done so it would have found that the increases in broadband prices it proposes are not necessary to deliver full fibre roll out in either Area 2 or Area 3.
- Ofcom has chosen to disregard the context which is Openreach's significant excess profitability in local access services across the UK over the last five years. From a position of SMP, Openreach has been able to extract profits well in excess of those determined by Ofcom to be reasonable. Indeed, in just in the last five years, Openreach has earned a staggering **£3.5 billion in excess profit in Fixed Access Markets and WBA Market A**. If Ofcom were to impose a CPI-0 charge control for MPF/FTTC 40/10 services for the next 5 years, then this **would result in an additional £3.4 billion in excess profit in the WLA market alone across the UK.** In accepting Openreach's offer in Area 3 and allowing prices to rise above costs in Area 2, Ofcom are abandoning UK broadband consumers to the certain fate of prolonged overcharging, with higher wholesale prices reflected in retail charges.
- Ofcom's proposal to accept Openreach's offer for Area 3 will allow Openreach the freedom to earn excess profits; The conditions offered by Openreach in making its offer are not necessary for Openreach to make an adequate return on fibre investments. They will simply allow Openreach to extract additional profits for BT shareholders at the expense of rural customers.

- Ofcom should have identified that Openreach's assertion that it needs excess profits from existing copper customers to subsidise its fibre build costs to roll out to 3.2 million home, i.e. that there is a 'fibre shortfall' is neither logical nor supported by empirical evidence, for example the willingness of rivals to overbuild Openreach's network in similar area shows that it must be possible to generate reasonable returns as a monopoly supplier. If Ofcom were to accept Openreach's offer, this would incentivise Openreach to demand yet higher prices in order for customers to fund its next tranche of investment.
- Ofcom's proposals overall, including accepting Openreach's offer in rural areas, would lead to Openreach making excess profits of the order of **£3.4 billion** over the next five years on copper services. The chart below also highlights the significant reversal in Ofcom's regulatory approach, as it will have gone from attempting to reducing excess profits over time (which remained substantial even in 2019/20) to deliberately allowing Openreach to exercise market power.

Openreach's excess returns in copper WLA services following Ofcom's proposals




*Source: Frontier Economics : For 2017/18-2019/20 – Frontier estimates based on BT RFS; from 2020/21 onwards, Frontier estimates based on Ofcom's projections in Access Review CPI-X Model or Cost modelling for active services.*

- Ofcom's proposals would lead to consumers paying around **£3.2 billion**[7] more for their broadband services than if Ofcom implemented a cost-based charge control over that period. This £3.2 billion additional cost is unjustified:
  - In Area 2, the relationship between regulated copper prices in the short period before copper switch off and pricing of ultrafast fibre services in the long term is clearly weak. As such increasing copper prices has little impact on the business case for fibre roll out but imposes significant costs on consumers before fibre is even available to them. In any case Ofcom's own modelling shows that a tighter charge control on copper services is still consistent with a fibre price level which would allow a new entrant sufficient returns to justify roll out. Setting copper charges at more than is strictly necessary simply results in consumers paying more for no corresponding benefit.
  - In Area 3, Openreach has only offered a non-binding[8] "voluntary commitment" to rollout fibre to 3.2 million homes of the 8.8 million homes in Area 3. There is no evidence that Openreach cannot make a reasonable return from rolling out fibre to these customers. Openreach's offer also leaves well over 5 million homes without fibre by 2026, despite them also paying higher prices to subsidise Openreach's roll out from 2021. These customers would not even benefit from any positive spillover effects of increased competition in ultrafast services, as Openreach will be the monopoly provider only offering at best superfast services. Experience from the WBA market shows that where a subset of rural customers have been left on legacy services, BT has been able to extract high returns while offering a substandard quality of service.
  - As a result, both in Area 2 and Area 3, consumers are going to pay more than necessary for Ofcom to meet its long-term objectives in terms of fibre roll out. In the midst of the COVID-19 crisis, where affordable and robust broadband continues to be a priority for households and wider society.
  - In Area 3, Ofcom has fundamentally miss-specified the barrier to investment, which appears to be that Openreach does not have an incentive to roll out fibre, when it can generate excess profits on its legacy network, rather than a lack of ability to generate reasonable returns on fibre investments. This mis-specification has led to Ofcom proposing to accept an

[7] Differences between estimates of the cost to consumers and the estimates of excess profits at a wholesale level reflect differences including in the assumption of 'pass through' of wholesale costs to consumers and the degree to which a cost based charge control would reflect the costs projected by Ofcom.

[8] Ofcom, July 2020, WFTMR 2021-26: Proposed approach to pricing WLA services in Geographic Area 3, para 3.16.

offer which would perpetuate Openreach's ability to generate excess profits power rather than considering policy options, consistent with regulatory best practice, which would target a higher level of fibre roll out while protecting customers.

- Incentivising monopoly network operators to upgrade their networks is a problem that has been addressed by other UK regulators such as Ofgem and Ofwat. Ofcom should draw on the experience of others in implementing its own approach as this is new territory for Ofcom.
- Implementing a best-practice RAB approach, which should (by definition) provide BT investors with a reasonable return while protecting customers. This would also allow Ofcom to set challenging outcome targets for fibre roll out and incentive mechanisms to ensure these targets are met, rather than passively accepting an Openreach offer; and
- In order to assess the ability of Openreach to roll out fibre networks in Area 3 it should be required to produce a detailed and well-justified business plan which is then critically assessed by Ofcom, as is the case for water companies and energy companies (as opposed to a simple acceptance of a two-page letter from Openreach[9] with a superficial assessment of 'value for money').

# What happened to 80/20 FTTC regulation in Area 3?

17. Ofcom has thus far not presented any evidence to demonstrate that 40/10 would be an effective anchor on 80/20. Indeed, there is a significant body of evidence to highlight that an anchor set at 40/10 will not be effective at constraining prices at 80/20. This evidence spans a number of independent data points. Ofcom's decision to reverse its original proposal to charge control 80/20 services in Area 3, through its acceptance of Openreach's terms, is clearly not in the wider consumer interest. Concerns over the lack of an effective anchor span both Areas 2 and 3, however they are particularly concerning for consumers in Area 3, given the expected lack of infrastructure competition.

18. In consideration of the need for an effective anchor, we would highlight to Ofcom that:

- 80/20 is now the volume FTTC product, outselling all other speeds by a considerable margin for new provides. It is increasingly regarded as an entry-level broadband service, with this perception only likely to strengthen further as FTTP availability grows and through the continued elevation in

[9] https://www.ofcom.org.uk/__data/assets/pdf_file/0032/198860/openreach-letter-26-june-2020.pdf

consumers' basic broadband needs as a result of changes to working and lifestyle habits in recent months.

- Some significant retail market players already refuse to offer speeds lower than 80/20, recognising the weakness of lower speeds in meeting customer expectation for fit for purpose broadband (particularly in respect to content streaming).
- ✂;
- Research by Ofcom and others clearly indicates that consumers rarely regress on broadband speed, Once they consume 80/20, then will never step down.
- Data consumption of 80/20 users is significantly greater than that of 40/10 users. Median data consumption of ✂.
- Given the considerable variability of FTTC technology, due to copper quality and line length, the average download speed achieved by an 80/20 users is around 63Mbit/s. There is no evidence to suggest that an anchor set at 80/20 would discourage fibre investment, particularly given the significant speed differential and the consistent and uniform performance offered by fibre.
- The COVID crisis has highlighted the inadequacy of 40/10 and ADSL speeds for many consumers. With many finding that, 40/10 is not sufficient to meet the demands of home working, home schooling or increased requirement for content streaming and now symmetric applications such as video conferencing applications such as Zoom and MS Teams where 10Mbit/s up may not be sufficient . With more businesses requiring home working, demand for 80/20 for home business use is now critical for many. This all comes at a time when both business and personal finances are under increasing amounts of pressure.
- The growing consumer appetite for broadband speeds and the progression of demand up the bandwidth gradient is not unique to the United Kingdom. Other European national regulatory authorities have taken the decision to charge control the full range of broadband speeds, aware that in the absence of regulation the incumbent will have the clear incentive to raise pricing well above competitive levels. For example, the German regulator took the decision to regulate FTTC pricing in 2012, initially for 25/50 Mbit/s VDSL and then later for 100 Mbit/s. The most recent BNetzA decision in 2018, included 175/250 Mbit/s within the scope of regulation. Ofcom's decision only to rest regulation on 40/10 appears considerably out of step with other NRAs.

19. We asked SPC Networks to independently analyse demand for services based on GEA 80/20 and GEA 40/10, examining the relationships between the two. In particular, we were seeking to

understand if GEA 40/10 would be an effective anchor of 80/20 pricing. To do so, SPC created two separate models:

- A price reaction model that tests how operators set prices of GEA 80/20 based products in relation to rivals' GEA 80/20 products and in relation to GEA 40/10 based products.
- Demand models for each of Sky and Vodafone  which assess how demand for retail products based on GEA 40/10 and 80/20 respond to prices.

20. The SPC analysis found that:

- UK broadband providers set prices of 80/20 based services taking account of the price of competitors' 80/20 based services but that they take no account of rivals' 40/10 based services;
- Demand for 80/20 based services for each of the two operators whose data are analysed is found to be independent of the price of 40/10 based services.

21. On the basis of these findings, it SPC's view that GEA 40/10 is not an effective anchor product. Indeed, demand for 40/10 is now so low that a retail service based on GEA 80/20 could be regarded as the entry-level broadband service. The unredacted report, which has been provided to Ofcom directly by SPC (due to the confidential nature of the respective data sets to both Sky and Vodafone), highlights the very poor performance of GEA 40/10 as an anchor product.

22. Any Ofcom decision to remove regulatory pricing oversight of 80/20 would leave broadband consumers vulnerable to the adverse effect of wholesale price rises from 2023 onwards (when existing fixed term pricing deals end). Openreach will have a clear incentive to take advantage of this situation and set prices above the competitive level as it is unlikely that infrastructure competition would be mature enough at that point to act as a meaningful constraint. Such a problem could easily be mitigated if Ofcom rejected Openreach's self-serving request to deregulate GEA 80/20. Given the growing importance of affordable, fit for purpose broadband to UK consumers it is vital for Ofcom to act in the consumer interest and safeguard the price of 80/20 GEA from 2021.

23. We also note that many broadband consumers continue to rely on a WLR line to consume their broadband. WLR acts as a copper bearer, performing a near identical purpose to MFP. It is vital these two inputs are regulated on the same terms (as copper bearers).  To do otherwise risks distorting retail broadband competition. If Ofcom wishes to avoid the necessary administrative process to confirm the product market status of WLR, then it needs to secure a meaningful pricing commitment

from Openreach not raise WLR rental pricing by more than CPI in the period up to the national stop sell date in 2023.

# The legal status of Openreach's letter

24. This section deals with three high level legal points:

- The Openreach letter of 26 June 2020 is not an appropriate basis for the decision Ofcom proposes to make;
- There is a material risk of Ofcom's fettering its discretion in relation to the period after 2026. More disclosure is needed;
- Ofcom's so-called "RAB" approach is unlawful more generally.

25. We elaborate on these points below.

26. In its WFTMR consultation of 8 January 2020 ("January consultation"), Ofcom framed the discussion about its approach to price regulation in Area 3 (primarily in section 2 of Volume 4). It said that it would consider a forecast approach to RAB pricing in Area 3 if Openreach gave appropriate commitments to invest in that area. It said this:

> *"Forecast type approaches to setting price caps are commonly used in other regulated industries that operate with a RAB framework (Vol 4, 2.27)"*

27. This is true in so far as it goes. However, in other sectors the forecast approach is usually linked to explicit, formal re-openers or clawback mechanisms. In many other sectors there are other controls as well. These include programmes such as "constructive engagement" where wholesale customers are actively engaged in the design of capital projects, which are then agreed; or ex post reviews of efficiency (and disallowance of capex) by the regulator. Regulators can also set licence conditions obliging regulated companies to deliver particular projects on particular milestones. There is, in short, a wide variety of tools at the disposal of regulators and, in other sectors, they are well understood.

28. Ofcom was obviously alive to the problem of principle here because it also said this:

> *The main challenge with this approach is confirming that Openreach's investment commitments would be sufficient and ensuring that Openreach delivers its committed investment programme. Our confidence that Openreach*

*will meet its commitments will depend on the nature of those commitments. In order for us to have confidence in a forecast approach, we would need to satisfy ourselves that either Openreach's commitments are robust or we have a way of enforcing any commitment that Openreach makes. (Vol 4, 2,29)*

29. This is, rightly, strong language: "the main challenge"; "ensuring that Openreach delivers"; "confidence", "robust", "enforcing any commitment". And Ofcom sets itself a two-limb test: either the commitments must be robust, or there must be a way of enforcing any commitment.

30. It is instructive that in the January consultation and in the current consultation Ofcom speaks in the language of commitments. Again, and rightly, this is a strong word. A commitment is something which is, more or less, binding.

31. Openreach's letter of 26 June 2020 is not a commitment. It talks in the language of plans: "we are planning", it says; and "our plans". The letter falls, at the first hurdle, in any claim to meet the tests that Ofcom set in January[10].

32. Ofcom can, therefore, have little confidence that Openreach will deliver. Openreach's "plan" that it will indeed build to 3.2m premises is not, in Ofcom's words, "robust".

33. Does Ofcom, then, have any way of enforcing the promises Openreach has made? How has it considered the wide menu of options it has at its disposal?

34. The answer is that it has not considered them:

- First, under its proposal, it has no way of enforcing the Openreach promise at all. It fails the test, therefore, that it has set itself.
- Nor has it considered any of the other options – clawback, formal reopeners, other controls.

35. To the extent that Ofcom does look at this problem it does so in only nine paragraphs – only just over a page – of its 41 page consultation. (Remember that Ofcom itself, in January, called this the "main problem" with a forecast approach.) And it only considers one option: an option under which it may use powers in future to disallow something like a possible £130m of cost recovery on copper assets in a future control period. The proposal is riddled with holes: for example, there is no

[10] Where Openreach uses the word "commitment" it does so only to refer to what action Ofcom may take – "We understand that Ofcom will need to consult on whether such a build commitment is sufficient".

guarantee that Openreach would have recovered those costs in any event; and those costs only extend to the cost of rollout to 1.3m premises, not 3.2m.

36. It is extraordinary that Ofcom has not considered a direct licence condition obliging BT to roll out its network; or any other formal, binding mechanism.

37. In short, the letter is a totally inadequate basis for Ofcom's plans in that:

- It fails to provide any real commitment at all; and
- Ofcom has no way of enforcing it.

38. The Openreach offer therefore does not meet the tests set by Ofcom in the January consultation. Those tests were reasonable, proportionate and proper.

39. If all that were not enough, the plans offered by Openreach are contingent on:

- Getting the broader regulatory treatment they want; and
- The course of Regulation post-2026.

40. There is nothing in Ofcom's January consultation about a broader deal to be done, or any other quid pro quo for Openreach rolling out fibre in Area 3.

41. Ofcom correctly notes that it cannot fetter its discretion in relation to future periods. However, the commitments it offers – at paragraphs 3.45ff of the consultation – are clear and explicit. There is no explanation of how the two are reconciled.

42. In particular, both Openreach and Ofcom refer to the "fair bet" principle. It is unclear exactly what is meant here. The fair bet principle is that the regulated company must have the opportunity to generate reasonable returns on its investments, commensurate with the risks involved. But the bet in question here seems to be one way: the RAB structure guarantees Openreach's returns, removing any real risk.

43. Ofcom therefore needs to explain exactly what it meant here by the term "fair bet". The use of the term in both Openreach's letter and Ofcom's consultation suggests there may have been further communication between Ofcom and Openreach than just the letter. We request that any such communication – including meeting notes – be disclosed along with any other documents which may clarify what actually is being considered.

44. More broadly, Vodafone is concerned about the lawfulness of the RAB approach. The RAB approach used by Ofcom allows Openreach excess revenue from one area / product set in return for a promise (as it happens, an unenforceable promise) to invest in fibre to the home. These arrangements are to be made under SMP conditions set pursuant to sections 87 and 88 of the 2003 Act.

45. As Ofcom is aware, those sections require that the measures in question are necessary in order to stave off the risk of excessive pricing, or of a price squeeze (section 88(3)). This is Ofcom's own view of how the statutory framework operates. Elsewhere in the consultation, for example, (para 1.61 of Volume 4), Ofcom says this (commenting on TalkTalk's proposal for price floors in adaptive regulation):

> *"In order for us to be able to impose a price floor as part of the charge control, we 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."*

46. Neither the January consultation nor the current consultation explains how this requirement is met by the RAB structure. Indeed, it is hard to see how it could be met, given that prices are actually to be increased for MPF and FTTC (as Ofcom puts it, "MPF and FTTC charges are marked-up to allow the recovery of Openreach's fibre investment costs"). Ofcom has, quite obviously, not sought to explain how higher prices for MPF and FTTC are necessary to prevent price squeeze or excessive pricing.

47. For this reason, the whole of the structure set out in the consultation will be unlawful.