

January 2015

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Level 3's Response to Ofcom Preliminary Consultation on Passive Remedies

Level 3 Communications UK Ltd welcomes the opportunity to submit the following comments for Ofcom's consideration. The possible introduction of passive remedies following the expiry of the current Business Connectivity regulations on 31 March 2016 would be a significant development and we agree with Ofcom's decision to conduct a preliminary consultation on the high level principles ahead of more detailed thinking on the subject.

General Comments

The supply of communications services to large public and private sector customers is a major component of our core business and the UK's Business Connectivity market is of considerable interest to us. Together with Global Crossing Telecommunications (UK) Ltd, which we acquired in 2011, we have been closely involved in all regulatory policy making in this area since wholesale leased lines were first considered by Oftel some 15 years ago.

A global company such as ours must make investment decisions based on our strategic view of the relative national markets and a crucial element of our decision process involves the provision of 'last mile' access to served premises.

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The introduction of a duct and/or fibre remedy would offer the potential for Level 3 and our competitors to increase capex budgets and offer innovative service solutions for the benefit of enterprise consumers.

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Should Ofcom eventually conclude that one or more passive remedies should be introduced, we would welcome consideration of the imposition of a penalty-free obligation. This proved highly successful when Partial Private Circuits were introduced whereby CPs were able to migrate their existing retail leased lines (many of which were contractually tied for long durations) onto the new wholesale offerings without triggering the early cessation penalties in the original retail contracts. Were such a requirement to be introduced here, CPs would be able to take up passive remedies much more quickly and efficiently than would otherwise be the case.

Question 1: Do you agree with our preliminary framework for considering the case for passive remedies?

We fully agree that it is appropriate to consider the case for passive remedies at this time. In our view, while 15 years of successive regulatory interventions have helped drive significant economic efficiencies, first in PPCs and latterly in Ethernet services, the access network remains an enduring bottleneck. The effect of CPs' continued reliance on BT to deliver last mile services has been to stifle competition at the service level since all CPs are essentially forced to offer 'me too' products. Further, as Ofcom will be aware from our previous dialogue and as articulated by UKCTA in its

November 2014 publication '30 Years after Privatisation: is the Telecoms Market Working?'¹, BT continues to experience significant problems that with its service delivery and fault repair functions. In our submission, a fundamental change is required in order to both (a) offer CPs an opportunity to invest and innovate and (b) create a real incentive for BT to address its service and operational shortcomings.

We note that CPs have historically faced strenuous challenges in persuading BT to develop new business connectivity products or feature enhancements to existing products and processes. Level 3 is particularly concerned at the lack of innovation and cost to develop product enhancements, especially moving forward under the Equivalence Management Platform (EMP) to enhance the existing active product set. It is our view that the availability of passive remedies would create a strong inducement for BT to concentrate its efforts on improving customer satisfaction in relation to active products as, over time, it would be necessary for BT to demonstrate to its CP customers that its active products were genuinely adding value.

The experience of copper unbundling in the UK and elsewhere suggests that if ducts and/or fibre were to be unbundled in an effective and efficient manner, this could not only lead to enormous benefit for UK consumers, but would enable the possibility of an eventual rolling back of active remedies. As Ofcom has noted, it would be imperative for both sets of remedies to coexist for some time in order to ensure beyond doubt that genuine competition had developed in the access market before a relaxation could be considered, but this would indeed be one logical consequence of a successful passive measure.

Although we acknowledge Ofcom's apparent concern about the pricing of bandwidth and intensity of network usage, we remain to be convinced that if access to ducts/fibres were to form a remedy, there should necessarily be any geographic restriction. The prospect that CP investment could be skewed towards areas which are outside of WECLA and hence not yet considered competitive at the retail level, is offset by the fact that CPs' network footprints are generally weighted towards the southeast of England. Hence, in our view, the immediate opportunity for cherry-picking outside of this region would be limited.

We do agree fully with Ofcom's intention to analyse economic efficiency, competitive impacts and distributional effects on consumer markets. Once the passive remedy toothpaste is out of the tube it will in practice be impossible to put it back so a critical part of the analysis will be to model the range of potential consequences and their respective impacts over the medium and longer terms. That this may be a challenging task is clearly understood.

With regard to the current and proposed developments at the EU level, we see this UK initiative as being extremely useful in helping the Commission reach an informed decision on the best way to approach the subject across all Member States. Crucially, if the UK is successful in this regard there is an opportunity to significantly improve both the attractiveness of the UK for inward investment in infrastructure and the quality/price mix of business connectivity services which would further enhance the UK's position internationally. We would urge that the economic research to be undertaken on this project should include consideration of these potential macro-economic consequences.

Question 2: Do you agree with our preliminary views on the potential benefits of passive remedies? Please provide evidence to support your view.

¹ <http://www.ukcta.org.uk/>

We acknowledge the logic of Ofcom's preliminary thinking and in particular the identification of at least three categories of potential benefit, viz: dynamic efficiency; productive efficiency and the ultimate reduction of the need to regulate downstream services. In our opinion, there may be additional benefits that have not yet been mentioned:

- Firstly, the opportunity for macro-economic benefits to the UK more generally which has been noted in our response to Q1 above.
- Secondly, there is the possible creation over time of a genuine carriers' carrier market for fibre- and wavelength-based access services which could enhance both the dynamic and productive efficiency elements. This would provide strong evidential support for the policy direction Ofcom has taken within the BCMR in relation to MI and WECLA.

In our experience, during the main network build period of the 1990s, a market began to emerge where CPs would see benefit in selling unlit fibre capacity to other CPs who were at the same time their fierce rivals at the retail level. Indeed, this nascent market displayed such promise as to persuade the Inland Revenue, through the Valuation Office Agency, to use the market price for dark fibre rental as the 'tone of list' basis for taxing all network assets, both leased and self-provided from 1995 onward. However, this market essentially stalled from 2000 onwards and is today virtually non-existent for new sales.

While traditional fibre leases were typically long term IRUs in keeping with core network expansion, it is possible that future lease/rental agreements could be tailored to match the term of the downstream service/s being supplied to business consumers. The current disincentive for such commercial activity at the wholesale level appears to have been heavily influenced by the strategic value placed on installed network assets by their owners. However, if the regulatory conditions were to change such that the average build costs for access infrastructure were dramatically reduced, then CPs would not place such a high premium on their assets which would, we anticipate, unlock a massive potential.

Furthermore, we understand that HMG is currently proposing to implement a number of Law Commission proposals in relation to the Communications Code that we understand is being tabled as an amendment to the Infrastructure Bill. Removal of some of the statutory barriers to investment in access fibres would strengthen the above argument.

In order to derive these benefits, it is essential that consideration be given to practical usability. Although any passive remedy, both duct and fibre, would conceptually result in the rental of property by the asset owner BT to the CP. From past experience, we anticipate that BT would seek to 'productize' its offering so as to ensure consistency of approach and the associated operational and administrative/commercial procedures.

As much as we don't understand why implementation of a passive remedy should be complex or difficult in theory, we are mindful of the challenges experienced by CPs wishing to consume Openreach's PIA product when they sought to replicate NGA products. This resulted in a number of CPs pulling out and the disappointing take-up of what was widely expected to be a useful offering. We would not wish any new Passive remedies within the BCMR to encounter the same issues in implementation and urge Ofcom to pay close attention to all elements of any prospective offering.

Finally, in order to derive maximum benefit from passive remedies, we would ask that consideration be given to whether the WECLA zone should be included within scope. Although we acknowledge that market conditions have been shown to be somewhat different, the 'cherry-picking' risk that BT has identified is naturally much lower since BT is already enjoying pricing freedom in this geographic area.

Question 3: Do you agree with our preliminary views on the impacts and risks of passive remedies? Please provide evidence to support your view.

We broadly agree with Ofcom's summary of the issues and identification of the main factors that need to be considered. In order to credibly analyse these factors, it seems reasonable to assume that the fundamental model for price regulation of active products (fully allocated cost constraint and pricing flexibility within a sub-cap regime) would not be materially relaxed with effect from April 2016. Indeed, as we have outlined in our response to Q4, there may be a need to pay particular attention to the nature of future sub-cap price regulation so as to ensure the stability of the market for upstream passive products.

We agree that under this current regime, BT has been able to over-recover a considerable proportion of common costs through its high bandwidth Ethernet offerings as has been clearly demonstrated in both Ofcom's own investigation and in CAT proceedings. A natural consequence of introducing passive remedies would be to create a strong incentive for BT to price its higher bandwidth Ethernet services at a level more closely aligned to its FAC and this in turn would drive significant consumer benefit.

We would challenge BT's reported view surrounding its level of network investment. We have seen little evidence that BT is investing greatly in its business connectivity network at all, either in the roll out of many more fibre nodes or in proactive maintenance/reliability improvements. Conversely CPs are seeing an increase in the amount of Deemed Consent applied to Ethernet orders due to infrastructure issues, a number of which will be down to capacity however BT's (Openreach's) reluctance to split this out prevents any published statistics being available.

We observe that improvements to BT/Openreach's capacity management processes & procedures would be required for any successful Dark Fibre remedy and, in all probability, for the duct remedy also. It is disappointing that Openreach has been unable to split the DC22 Deemed Consent code into sub codes as this would have provided some useful data to inform the current discussion. We also note that although DC22 has been subject to Industry discussion within the Ethernet Service Forum, this has since been dropped from the agenda which has effectively prevented all further debate at this level. Although Level 3 has sought reinstatement of this item on the agenda, we are not optimistic that this will be achieved in the absence of Ofcom intervention. Ofcom could also helpfully use its information-gathering powers to obtain further data in this regard.

In relation to the prospect for innovation (4.16 et al) we strongly agree that this is possible. As Colt has already observed, new topologies may indeed emerge which would enable, for example, the offering of contention services to multiple businesses in a localized area. Passive Remedies could also be used where currently there is no technical solution within the existing Active product set such as C-RAN.

Question 4: What are your views about the potential impact of passive remedies on the pattern of common cost recovery and the associated distributional impacts?

With regard to the possibility that BT could face difficulties in fully recovering its common costs were passive remedies to be introduced, we expect that the risks ought to be manageable. While the extracts from BT's regulated financial statements show relatively large values for common cost recoveries in recent years, there is considerable scope for BT to make efficiency gains, particularly during the early years of a passive remedy regime as it will take several years in practice for CPs to take full advantage of new passive-based opportunities.

As Ofcom observes, the increasingly costly legacy products, particularly ISDN, are in gradual decline. In relation to TI products, we ourselves have seen ✂

Similarly, even in the absence of passive remedies, we predict that ✂ during 2015-2016. One consequence of the anticipated imposition of passive remedies would be to hasten the end of these inefficient products and their contributions towards common costs. Ofcom will doubtless have a view on whether there has been any material impact to WLA Market with the introduction of Passive Remedies for NGA (Next Generation Access) replication and this may also inform predictions as to the impact of a more general passive access remedy.

At a general level, next generation networks are using IP switching which has an inherently much flatter cost structure than TDM. Hence any remedy that has the effect of flattening the retail price levels (as Ofcom observes in 5.24) will be compatible with pricing trends for the switched services that typically consume the access products under consideration. We do not therefore consider this to be an undesirable consequence of passive remedies.

We acknowledge that one of the most difficult factors to predict will be the dynamic impact of the influence that price changes to active wholesale products will have on the adoption by CPs of passive remedies. In order to minimise investment risk, we would greatly welcome a tight throttle on any potential for dramatic price fluctuations.

Ofcom will recall that one unanticipated consequence of the mobile call termination regulation prior to it being addressed in 2010 was that MNOs were permitted to legitimately ‘flip-flop’ their wholesale charges while remaining within the bounds of the charge control. We are concerned that the BCMR remedies should be designed to ensure that the stability and predictability market for upstream passive products is maintained as tightly as possible, particularly during the term of the next regulation (2016-2019).

In order to predict with any confidence the likely take-up of a passive remedy, it will be necessary to consider all costs faced by CPs’. These may vary somewhat between building to new customers on the one hand and substituting active service for passive on the other.

Question 5: Do you agree with our initial view that mobile backhaul and fixed broadband backhaul are likely to be the primary applications with significant demand for passive remedies?

Although we agree that mobile backhaul and fixed broadband backhaul are likely to be the applications with significant demand, any passive remedy should not be restricted in its use as many CPs including Level 3 would be very interested in to making use of passive remedies for Business Connectivity.

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A critical factor in relation to practical usefulness of a passive remedy would be the physical points at which the CP could connect to BT’s estate. In-building termination points are only optimal in cases where the CP already has a presence, not only in that building, but also to some extent within the same part of that building. We would strongly favour an outcome where the CPs would be permitted to request a passive remedy to be delivered to a CP Point of Presence (POP) located outside of the curtilage of the BT exchange building. Should any incremental civil costs be incurred in this model, then these could be itemised and met by the benefitting CP along already established lines for excess construction.

Question 6: What benefits might duct access offer over dark fibre and vice versa? Is there a case for having both remedies?

Level 3 is supportive of both duct and fibre options and possibly a hybrid of the two. To the extent that duct space was not available due to congestion or the state of repair of the infrastructure, then a dark fibre option would be a suitable alternative.

A duct access Remedy would elegantly avoid having to resolve issues that we have consistently encountered seen with BT's (Openreach's) capacity management & fibre planning areas. However we foresee the prospect of added complexity when CPs seek access to Openreach's chambers so as to deploy their own fibre systems. We also anticipate that, in the absence of an appropriate incentive, BT is unlikely to recover redundant or unused cables so as to create space for its competitors to fill. Hence we would propose that efficiency targets be set and that a regular spot check audit be established so as to measure compliance.

We anticipate that there would be reusable components from the WLA passive remedy that could be re-deployed in order to speed implementation within a BCMR remedy. However, we caution that the very limited success of the current WLA remedy is in part due to frustratingly onerous processes and procedures ✂. In the absence of a full review of the process, the investment and competition opportunities would not be delivered. The number of CPs that have now backed away from the WLA passive remedy strongly suggests that we are not alone in this view.

We would strongly support any move to subject any/all upstream passive remedy/ies to an equivalence of inputs (EOI) requirement. Not only would this help to ensure that the investment and competitive playing field is more level, but BT would also be able to benefit from the freedom to introduce greater innovation in downstream markets.

We note Ofcom's initial preference for a dark fibre remedy. Dark fibre, while less attractive to us than a duct or duct/fibre hybrid model, would still offer some tangible improvements over the current situation. However, in view of the planning and implementation issues noted above, we suggest that consideration be given to (a) a suitable compensation regime in cases where BT fails to deliver what can be reasonably expected and (b) oversight by the OTA of all practical and procedural aspects of a fibre solution.

We bring to Ofcom's attention that ✂ ✂

Question 7: If passive remedies were restricted to particular product types or geographic areas how might this affect the usefulness and benefits of the passive remedy?

In order for Level 3 to make significant use of any passive remedy, be this duct, fibre or a hybrid, it is essential that we would be able to use the infrastructure to deliver Business Connectivity / Leased Line downstream services. As an absolute minimum, we would need to use the passive access to deliver our existing products including Ethernet Private Line and Wavelength services as well as to provide more efficient Ethernet aggregation & backhaul solutions.

If this were not the case, then it seems likely that we would be placed at a material disadvantage to MNOs and LLU operators if they are themselves able to use the remedy in order to deliver their core products and services. In order to future-proof the development of innovative new products and to anticipate the increasing market convergence that is underway, we would strongly urge that no service restriction be permitted whatsoever. As expressed above, once a more comprehensive economic analysis has been conducted, we do not believe there will be as strong a case for geographic segmentation as has been implied.

Question 8: What arrangements would be appropriate for the supply of new infrastructure for passive remedies?

For the reasons given above, Level 3 believes that the most effective remedy would be both a duct and fibre one and, of the two, we see greater potential benefit from the opening of duct access. In relation to duct access and, provided suitable contractual indemnities were in place, it is unlikely that there would be any necessity for BT to build new duct infrastructure as the construction work could be undertaken by the CP's contractors.

As for dark fibre, there has been much consideration in recent years of BT's Excess Construction Charge

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One trade-off that would arise from any new infrastructure build by BT would be a continuing strengthening of BT's balance sheet that ultimately will improve BT's access to the capital markets and reduce its cost of capital.

Question 9: Do you agree with our initial views about the non-discrimination arrangements for passive remedies?

We fully support Ofcom's focus on this important area and completely agree with Ofcom's preliminary view that any passive remedy should be introduced on an EOI basis. As noted in clause 6.32, downstream Lines of Business may choose to consume a passive product for particular application eg Mobile Backhaul. Furthermore, downstream Lines of Business may wish to consume a passive remedy in MI or AI for Ethernet Aggregation purposes at the edge of its network, or to provide E-NNI capability into its existing Ethernet platform, similar to how BT today provides an exchange building handover capability branded as Ethernet Exchange Connect which consumes Cablelink.

If a Passive remedy with an EOI obligation were to be introduced, we would anticipate that there would also be an overriding 'no undue discrimination' requirement so would expect there to be appropriate record keeping in order to validate compliance.

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Question 10: In light of the trade-offs identified, which broad options on pricing do you consider would be most appropriate for passive remedies and why? Please also provide details if there is another pricing approach you consider would be appropriate in light of the considerations identified in this section.

We consider a fully allocated cost-based approach to be the most appropriate, reflecting the underlying costs of the passive infrastructure used. This approach would remove barriers to entry and incentivise innovation and agree with Ofcom's observation (7.18) as to its relative simplicity. ✂ ✂

Although we accept that implementation costs would need to be recovered, we are not convinced by Ofcom's initial view (6.39) that these could be significant. There is a concern that unless strict accounting scrutiny is applied, there could be scope for uncertainty over precisely which costs are being recovered.

We would be opposed to any proactive rebalancing of prices until it is clear what effect a passive remedy has had on the market for active products as any pre-emptive adjustment may lead to BT over-recovering incurred costs.

Question 11: If a value-based (active minus) approach to pricing dark fibre were adopted, what do you think would be an appropriate active wholesale product (or products) to reference?

While we can see some reasons why Ofcom might consider this an attractive option, we do not think this is an appropriate approach to pricing a dark fibre remedy for several reasons. In addition to the fundamental concern that the price would be set at an artificially high level, we offer the following further observations:

- The active products are priced in relation to common costs which bear little direct relationship to infrastructure costs. In its 2010 RFS, for instance, BT justified its c.£2Bn revaluation of its duct assets on the basis that the critical economic driver was the cost of construction.
- There would be considerable risk that any cost over-recovery at the active level would result in inflated passive access prices.

The market rental prices for duct and/or fibre infrastructure forms the basis for assessment by the VOA of business rates for CPs entire (self-provided plus leased) network. There is a considerable risk that an unintended consequence of rental prices that are artificially higher than is already the case for leased dark fibre more generally in the UK would result in CPs facing much higher taxes than at present. Indeed, as BT is assessed on a different basis from other CPs except for Hull which is the same as BT (✂), there is a very real prospect that the value-minus approach could exacerbate what is already an asymmetric taxation regime. We urge Ofcom to fully understand the possible taxation implications before giving further consideration to this model.

Question 12: Do you have any other comments on the issues raised in the document or comments that might aid our consideration of the passive remedies as a whole?

With reference to para 7.39 we note that the price of BTs active products did not change when it moved between dual fibre working and single fibre working and so we would expect a passive remedy to be priced in a consistent manner.

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In relation to a possible duct remedy, we anticipate that contractual negotiation of specific commercial terms would be required in addition to appropriate pricing and adoption of appropriate common civil procedures. A helpful precedent for the commercial negotiations might be the tactic adopted by Oftel in its March 2001 determination

requiring the introduction of the then new PPC portfolio (including pricing and contract terms) within a period of 14 weeks. This timescale, while challenging was well supported by CPs and except for the pricing which was subsequently disputed, all other terms were successfully agreed. Indeed, as much of the work has already been done in relation to the existing PIA offering, there is even more reason to expect a rapid development and implementation.

Likewise, a similar approach could be adopted in relation to a possible dark fibre remedy. In practice, this could prove even more straightforward in relation to the commercial terms and in view of an already common approach to the engineering aspects, we believe that a new reference offer could be launched in somewhat less than 3 months from initiation.

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