Vodafone's response to Ofcom's Broadband USO consultation

February 2019

Contents

1. Executive Summary

To build Gigabit UK, we need a regulatory framework that incentivises investment. Today, just 4% of UK homes have access to full fibre, compared with 71% of homes in Spain and 89% in Portugal. If we are to meet the Government's goal for full fibre to reach all residential and business customers by 2030, we need to have the right framework in place.

Vodafone is concerned that Ofcom's broadband proposals lack ambition and fail to address the structural problems that have led us to the position set out above. Ofcom's current proposals will provide consumers in underserved rural areas with a broadband service at the lower end of today's service experience at a price that is potentially double the national average. This is at the same time as allowing BT to claim yet more funds for copper roll-out, with little or no prescriptive processes in place to ensure claims, funding mechanism, and competition are given the attention they require.

The issue of poor broadband coverage in rural areas is not new. However, it has persisted for many years due to two factors. First is Ofcom's policy of not incentivising or putting regulations around investment in the fixed telecoms industry. This has allowed BT to make significant excess returns in the fixed broadband market, secure massive state aid allocations for rural roll-out to preserve the legacy copper, whilst presiding over a network that fails to deliver a quality broadband experience for all.   Second, the inadequate approach to monitoring and regulating BT's use of BDUK state aid funds has led to an outcome that has failed to ensure maximum consumer benefit. There are valuable lessons that must be learned to ensure better results for consumers going forward. Given this backdrop of massive state subsidy and BT's significant excess returns earned through regulatory holidays and light charge controls, there is a significant amount of industry and consumer frustration that any broadband USO intervention is even necessary at this point in the evolution of the consumer broadband experience.

We welcome the focus on rural broadband and agree that social and economic exclusion due to a poor broadband connection is an issue that needs addressing. We have for a number of years published an annual report on the profitability of the incumbent operator, BT, and attempted to highlight the excessive profits they make from rural areas whilst providing a sub-standard broadband service at prices equivalent to much higher speed services. We have been calling on Ofcom to address this issue of underinvestment and the need to regulate to either (1) reduce Openreach's returns in these areas, or (2) ensure that BT re-invests their excessive profits to enhance the level of broadband services.

However, Ofcom has not acted. As a consequence, BT has not invested in these areas, and therefore the issue of a significant minority of consumers underserved by the broadband market persists. Ironically these are the very areas where BT has enjoyed the greatest profitability (in the WBA market), reporting regulated returns of approximately 60% for the last five years which have amounted to excessive profits of nearly

£1bn[1] over the last five years. In addition to this, BT has had access to the £1.6bn[2] of BDUK funds for the roll-out of copper-based superfast products. £700m of this is currently sitting on BT's balance sheet.

Ofcom is now proposing to implement a mechanism whereby potentially more funds – a yet to be determined amount – over and above the £1bn of excessive profits and the £1.6bn of BDUK funds should be given to BT from a source as yet to be identified in order to fund the roll-out of copper-based broadband services. The prospect of BT's competitors, or tax payers, funding BT's network expansion when BT shareholders have benefited for years from a regulatory regime that has failed to ensure the prioritisation of rural broadband is completely unacceptable. This consultation risks undermining the wider aspirations of government because:

- Yet more funds, this time from industry, will be spent on copper-based broadband services and controlled by the incumbent BT, rather than on fibre services controlled by competing operators.
- Ofcom appears to have designated BT as a universal service provider, as opposed to the legal and operating entity Openreach. The legal separation of Openreach and the ability for all operators to retail Openreach's products is fundamental to the current regulatory framework.
- Instead of focusing on investment and industry development, operators will have to assess the risks and potential costs of funding this scheme, which are unlikely, under Ofcom's proposals to be known until after the event.
- It creates uncertainty in the market, surcharging BT's competitors and undermining alternative Communication Providers' own investment plans. The size of any potential costs industry might face are opaque, and the operators that will be included in any industry fund are unclear. This generates yet more risk and uncertainty at a time where the industry needs a stable, certain, and clear regulatory environment that helps to attract investment
- Its appears that customers in these underserved areas, even after having a Broadband USO service installed, will still be receiving a sub-standard service compared to the rest of the UK whilst also paying the highest prices in the UK. BT Consumer currently charges £35 per month for superfast broadband services and Vodafone charges £20 per month. Ofcom is allowing these designated USO providers to charge up to £45 per month.
- Ofcom is not even ensuring that the designated USO provider, BT, uses other operators' networks where it is more efficient to do so. This is despite the fact that mandating the use of other operators' networks would encourage a more competitive roll-out.

[1] Figure 15 Annex A – Frontier Investment and profitability report.

[2] See Annex B - Ensuring transparency when network providers use your money to upgrade their infrastructure report.

We call on Ofcom to consider the issues we have raised in this response and make adjustments to the Broadband USO so that it consistent with the strategy for consumer fibre rollout by:

- Investigating fully BT's use of the BDUK funding programme,[3] ensuring efficient use was made of these funds and that these funds were used to serve the largest possible footprint of consumers possible.
- Investigating the £700m of deferred BDUK funds sitting on BT's balance sheet. These funds could be used to roll-out fibre in these areas, thus solving the Broadband USO issue for years to come rather than just putting in place a temporary, slightly improved service.
- Making allowances in the funding claw-back scheme for the vast scale of excessive profits BT has been enjoying in these remote and rural areas (WBA, market A). This will reduce the funds required by industry for legacy copper broadband and enable industry to invest capital in the future to meet the government's consumer fibre aspirations.
- Designate Openreach as the Broadband USO provider, ensuring that other operators can also retail B-USO products. This is consistent with Openreach legal separation and will help to ensure that retail pricing for these customers benefits from some degree of competition.
- Mandate BT (or preferably Openreach) to use other operators' networks in remote areas where possible, especially if those networks are fibre enabled and may help to provide an enhanced service for consumers.

[3] See Annex B - Ensuring transparency when network providers use your money to upgrade their infrastructure report

2. Scale of the issue

Ofcom explain in their consultation[4] that the number of premises that could benefit from the Broadband USO could be less than 860,000 when you exclude the premises that will be above the £3,400 installation cost threshold. Ofcom also explain that this number has significantly dropped in the last 5 years due to commercial and public rollout plans, from 15% of the population in 2014 to 3% in May 2018.

The table below, which is taken from Ofcom's consultation,[5] shows the distribution of the 860,000 premises, showing that the majority, in terms of volume, are in England. However, these are not all in remote and rural areas. This is because the predominant provider, BT has rolled out superfast broadband services in part as a response to competition from other providers, mainly Virgin Media. This means that there are pockets of urban areas not covered by Virgin Media's footprint that have not received superfast broadband services, even though it would be commercially viable for BT to roll them out. We estimate that over 280,000 premises in the England number fall into this category, and that 108,000 of these are in the Greater London area.

Table 1: Premises unable to receive 10Mbit/s download and 1Mbit/s upload sync speeds (May 2018)[35]

	UK	England	Northern Ireland	Scotland	Wales
Percentage of premises	3%	3%	6%	5%	4%
Number of premises	860,000	627,000	47,000	131,000	61,000

Source: Ofcom

Although details of the funding mechanism are not clear, Ofcom must ensure it includes safeguards that ensure BT is not receiving funding for rolling out Broadband services in urban areas that are commercially viable. Vodafone appreciates this is not a simple task; the Broadband USO provider has a huge information advantage. Ofcom can only request the information they feel might be helpful, whereas the Broadband USO provider can choose to provide the information that is most helpful to their cause of ensuring the maximum funding possible.

[4] https://www.ofcom.org.uk/__data/assets/pdf_file/0024/129408/Consultation-Delivering-the-Broadband-Universal-Service.pdf
[5] Table 1, https://www.ofcom.org.uk/__data/assets/pdf_file/0024/129408/Consultation-Delivering-the-Broadband-Universal-Service.pdf

3. Other funding – BDUK & excessive profits

Government BDUK Programme

Vodafone UK believes the Government should require network providers such as BT to publish detailed reports when using taxpayers' or other competitive operator's money to improve privately owned digital infrastructure. In 2017 we wrote a paper explaining why this is the case[6], drawing on extensive analysis of the BDUK programme. We wrote this paper in 2017 in response to the Government's proposal for a Broadband USO. The proposal immediately sparked debate about what the Broadband USO would look like, what technology it would use and who would pay for it.

Broadband Delivery UK (BDUK) was a Government programme launched in 2013, which channeled public money to fund BT network build. Like Broadband USO, BDUK was created to prevent digital exclusion; one of its goals was to provide everyone in the UK with a basic broadband speed of at least 2Mbps. We attempted to assess BDUK's performance to see if there might be lessons we could apply to the Broadband USO initiative. As a result of the reporting requirements imposed on BDUK and on BT being limited and non-specific, there is insufficient data to measure performance and ensure an appropriate level of project transparency or accountability. As we detailed back in 2017, even when key figures are available, the numbers are often unaudited and contradictory. As a result, we are unable to answer even the most basic questions, such as:

1. **What has been delivered and what was supposed to be delivered?**
2. **Where has it been delivered?** Where did BT's commercial roll out end and where did the BDUK programme begin?
3. **What has actually been spent?** We could not find any audited reporting of basic cost performance such as cost per cabinet rolled out, cost per home passed or cost per customer.
4. **Who paid for what? Although BT is responsible for matching part of the BDUK funding received from Central and Local Government, the amount BT contributed has not been formally reported anywhere.**
5. **What type of technology has been deployed?** The type of technology used to deliver the BDUK programme has a significant impact on costs, but we could not find any information on the amount of fibre to the premise (FTTP) rollout versus fibre to the cabinet (FTTC).

As an immediate priority, the Government and Ofcom need to understand and report on what BDUK actually delivered and why it did not solve the totality of the problem.

In addition, BT Group currently have over £700million of BDUK funds sitting on their balance sheet.[7] The notion that Government, Ofcom, industry, or anyone would provide BT with more funds to rollout copper-

---

[6] See Annex B - Ensuring transparency when network providers use your money to upgrade their infrastructure report
[7] BT PLC.com results page, q2 2018/19, PDF doc on results, page 6 on Capital Expenditure.

based broadband services when they have such amounts un-used on their balance is incomprehensible. Vodafone requests that Ofcom investigate these amounts and where they are going to be directed in the future.

Excessive profits in the WBA – market A area

Until 2018, Ofcom charge controlled wholesale broadband prices in rural areas where BT, as the designated Broadband USO provider, is now seeking additional funding to deliver 10Mbit/s broadband. In July 2011, Ofcom implemented the first charge control that set the price BT had to charge their retail division and other operators for wholesale broadband services in these areas.[8] BT's wholesale broadband access product, IPstream, has been subject to this charge control since then, i.e. a period in excess of five years.

BT will now seek funds through the broadband USO mechanism after investment in rural markets which are likely to be the very same geographies, households and businesses that have been covered by this WBA Market A charge control. The allowable regulatory return in this market (referred to by Ofcom as Market 1 pre 2014 and Market A post 2014) and in these geographies has been designed for the last five years to allow BT to invest and receive an appropriate return for that investment: BT have chosen not to do this and thus made supernormal profits.

Frontier Economics' analysis of BT's 2016/2017 Regulatory Financial Statements ("RFS") is attached in Annex 1. It has found that in the last year alone, the Wholesale Broadband Access Market in market A areas has delivered excess returns (returns above the allowable regulatory return/WACC) to BT of over £150 million.[9] This is in part due to Ofcom setting prices on the basis that BT could recover the WACC and depreciation charge for an additional £332million of investment in the market. There is even an argument to suggest that due to the length of the debate on Broadband USO funding (more than three years) that the prospect of some kind of state aid or industry fund may have had the effect of discouraging BT from investing itself, with it being more financially astute to wait instead for new sources of funding to be made available.

Ofcom's regulatory approach assumes BT would have invested in this market

When Ofcom constructed the cost stack for WBA services in rural areas (currently referred to as market A) they found that the underlying assets (SDH, ATM network, and the exchange DSLAM equipment) were heavily depreciated, such that the mean capital employed by BT in the market was very low. Modelled in the usual way this would have led to lower wholesale charge controlled prices. However Ofcom 'uplifted' the cost of this asset base in their cost model to enable/or because BT were investing in 21CN equipment and Ofcom did not want to discourage investment.

> *"The last adjustment was necessary because a number of the assets used in the WBA market are fully depreciated. This is not consistent with our "hypothetical ongoing network" (HON) assumption, where in the absence of investments in 21CN, BT would*

---

[8] https://www.ofcom.org.uk/__data/assets/pdf_file/0024/36942/statement.pdf

[9] BT's RFS section 5.1; WBA market A, mean capital employed = £373million, return = £206million, regulatory return = [mean capital employed x WACC] http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2017/RRD2017Final.pdf

have had to replace these depreciated assets. As a result, some of the asset values in BT's data were below the level consistent with what we believed a "steady state" value would be. Specifically, we believe that, on average, assets in a steady state would be half way through their economic lives. As such, BT's financial data were unsuitable as a basis for projecting the costs of a hypothetical ongoing network."[10]

"BT's costs for maintaining the broadband network may be increasing due to the age of the equipment and this could be reflected in its view on efficiency. However, the HON adjustment allows for aging assets to be replaced and so higher costs related to maintaining an aging network would not arise. We believe this provides some support for a higher efficiency assumption to reflect the lower operational costs arising under our HON approach as compared to BT's actual network costs, though we also note that we have increased asset lives in our model, and this could reduce the effect of this. [11]

Ofcom's policy decision allowed BT to recover additional depreciation charges and cost of capital on assets that did not exist by producing a pricing model that inflated the WBA cost stack. The purpose of this was to ensure that when BT did invest they would receive a return thus ensuring BT continued to invest in this market. However, BT did not.

Ofcom forecast for BT to invest and allowed them a return on this investment

In the WBA charge control, asset depreciation and mean capital employed were both increased to allow BT to invest in 21CN equipment. Although Ofcom has published not all the detail for confidentiality reasons, we can see the scale of the uplift in the regulated accounts.[12] Appendix 3.3 of the RFS requires BT to report the level of returns in the WBA charge controlled market, making adjustments to its asset base so that the capital employed is in line with the investment Ofcom forecast at the time of the charge control. In 2017 the reported capital employed that requires adding (i.e. is still to be spent) to bring the level of actual capital that BT employs in this market up to the allowable and expected amount in the charge control is £311 million. Therefore, we can conclude that BT has not invested as forecast and allocated to do by Ofcom's regulation, and as a result have enjoyed supernormal profits from these customers.

The actual return on capital employed in the WBA charge controlled remote rural areas is reported as being over 60%. If we compare the capital employed in this market in 2016 with the actual in 2017 it can be seen that the capital employed only increased by £5 million. Therefore, we conclude that BT have, in the last five years, made very little investment in this market and enjoyed supernormal profits for a number of years. Although Ofcom has not published all of the detail in the consultation for confidentiality reasons, BT's regulated accounts show the scale of the additional capital investment allowed through regulation compared to what BT has actually invested.[13]

---

[10] Paragraph 5.66 https://www.ofcom.org.uk/__data/assets/pdf_file/0024/36942/statement.pdf
[11] Paragraph A7.190 https://www.ofcom.org.uk/__data/assets/pdf_file/0027/63675/statement_annexes.pdf
[12] 'Appendix 3.3 Adjusted Performance Summary 2016;
[13] 'Appendix 3.3 Adjusted Performance Summary 2016;

In 2017, the reported capital employed is some £311 million lower than the charge control allowed. Therefore, we can conclude that BT has not invested as Ofcom had forecast or expected under the previous charge control, and has enjoyed supernormal profits as a result. The actual return on capital employed in the WBA charge control in rural areas (Market A) is reported as being over 60%. If we compare the capital employed in this market in 2016 with the actual in 2017, we see that the capital employed only increased by £5 million. Therefore, we can comprehensively conclude that BT has, in the last year and in the prior 5 years, made very little investment in this market and enjoyed supernormal profits. Despite this, it is now possible for BT to seek further funding in these areas through this proposal.

4. BT as the designated USO provider

In 2016,[14] Ofcom published its Strengthening Openreach's Strategic and Operational Independence statement. In it Ofcom stated:

> *Ofcom is pressing ahead with its plans to improve broadband and telephone services for people across the country, pursuing better service quality and encouraging greater investment in networks. Creating a more independent Openreach – which works in the interest of all providers, not just BT – is an important part of achieving this.*
>
> *We are disappointed that BT has not yet come forward with proposals that meet our competition concerns. Some progress has been made, but this has not been enough, and action is required now to deliver better outcomes for phone and broadband users*

We cannot understand why BT is a USO designated broadband provider. BT does not run or operate the Openreach network. Indeed BT is only supposed to have arm's length control over Openreach and is not present on the Openreach boards. Statements like the below in Ofcom's consultation are therefore very concerning:[15]

> *BT proposed that it would initiate network build (by Openreach) only when sufficient demand is achieved in an area. BT would recover the unfair net cost burden through the USO fund.*

How can BT initiate network build by Openreach when Openreach is supposedly a separately controlled legal entity? And how can BT recover the unfair net cost burden given that BT will not incur any costs, only the network operator Openreach will?

This is another good example of why this broadband USO proposal is incompatible with Ofcom and Government's wider strategy on consumer broadband regulation and fibre rollout. Ofcom needs to

---

[14] https://www.ofcom.org.uk/consultations-and-statements/category-1/strengthening-openreachs-independence

[15] Paragraph 5.48, Ofcom's consultation

Vodafone Limited, Vodafone House, The Connection, Newbury, Berkshire, RG14 2FN, England. Registered in England No. 1471587

reconsider their proposals and designate Openreach as the Broadband USO provider, and allow other retail operators the opportunity to drive prices down for these customers in remote and rural areas.

5. Pricing and service quality

In their consultation Ofcom quote a range of monthly prices for superfast broadband, and the associated paragraphs[16] are very confusing. Drawing out the important facts; BT now charge the majority of their customers (i.e. in-contract customers) for copper and fibre services £24.99 and £29.99 per month respectively. We currently have a superfast broadband offer of £20 per month. Superfast services are considerably enhanced when compared to the offering the Broadband USO is promising. Even so, Ofcom is preparing to allow Broadband USO providers, which are likely to have a local monopoly in the Broadband USO areas, to charge up to£45 per month.

Therefore, consumers receiving a Broadband USO's services will likely receive a service that is at least 50% slower than the average national broadband service and pay approximately double for that service. This is not in line with Ofcom's strategic aim of making digital telecommunications work for everyone. We very much doubt consumers in remote and rural areas will consider that telecommunication services are working for them when they:

- Potentially pay double the national average monthly broadband price.
- Receive a service that is likely to be 50% slower than the national average, and
- Have to wait even longer for a true fibre broadband service because competing fibre providers are discouraged from rolling out fibre in the area as consumers have a slightly reduced need for it.

6. Funding and uncertainty

Record keeping and Broadband USO funding claims

The Funding, proposed obligations on performance reporting and records maintenance is a very detailed and complex subjective area which Ofcom have provided no clear directions on. Identifying what – if any – unfair burden rests with the Broadband USO provider is an art rather than a science. What the designated Broadband USO provider will receive after installing a connection is 'generally' a broadband customer who has no choice of alternative supplier and is wholly reliant on the USO supplier to provide services. This represents a captive customer who may feel compelled to make use of other products within the supplier

16 Paragraph 8.4, Ofcom's consultation

bundle to reduce their overall expenditure. Indeed, in the competitive market, many providers upsell additional services to Broadband customers, with profitability viewed across the bundle and some elements of the bundle sold close to cost. BT, for example, can upsell TV / Sports content, mobile services, and other value add products to this captive customer base.

That is why Ofcom should consider the range of revenue streams that can be captured from a Broadband USO customer and not just the basic broadband revenue. They should also consider the revenue streams over a long period because that customer has little option to switch.

Vodafone is very concerned about Ofcom's hands-off approach to the reporting and records that operators need to maintain. Ofcom states:[17]

> *We consider that the Universal Service Providers are best able to judge, in the first instance, what accounting information needs to be recorded and maintained in order to support any net cost claim.*

Vodafone considers that there is a strong incentive on the USO to obscure the facts and reduce transparency. Given the lack of contestability, there are likely to be few genuine confidentiality concerns and a strong public interest argument to disclose this information.

We understand that Ofcom have suggested some cost categories and some potential minimum level of information that providers should record and report when seeking funds, but again Vodafone find this wholly inappropriate. Ofcom should be specifying the completion of detailed pro-forma documents and ensuring that (a) all operators and claims contain similar information, and (b) the information is sufficiently comprehensive to ensure a valid assessment is made by Ofcom.

Vodafone requests clarity as to Ofcom's response in the following situation. A designated Broadband USO provider submits data that Ofcom deems insufficient to validate the claim. The operator responds that it cannot retrospectively collect information, and if Ofcom requires specific, detailed information, it should have made this clear from the outset. What would Ofcom's reply be?

We consider Ofcom will seriously reduce its ability to challenge Broadband USO claims if it does not specify the precise data that is required before the fact. Ofcom should also specify that the Broadband USO provider must have an independent auditor in place to audit its reporting and the records used to justify any funding claim.

Source of the funding

We understand that Ofcom is proposing to consult on the funding for USO services later this year. We note that Ofcom states:[18]

> *We do not consider that prospective Universal Service Providers require information on funding arrangements in advance of making our designation decision because it should not affect how they will fulfil the obligations to deliver USO connections to eligible*

[17] Paragraph 9.30, Ofcom's consultation
[18] Paragraph 10.16, Ofcom's consultation

customers. We expect to consult on funding regulations in summer 2019 but we will review the position and provide an update at the time we publish our statement on designation. At that stage we will have the benefit of taking into account our decisions on who should be designated and what universal service obligations should apply to them.

Vodafone does not understand this approach. It would appear analagous to a shopper going out to purchase an item without any mechanism in place to fund the purchase. We believe the absence of these key details creates unnecessary risk and uncertainty for the wider industry, and results in even more risk and uncertainty for the Broadband USO providers.

We would also like to understand what would happen if the following scenario occurs. Let's say that in the summer when Ofcom consult on the funding mechanism, the respondents provide detailed policy, legal, and operational responses, that take further time to consider. Then when Ofcom conclude on this matter, operators appeal and the process is stuck in the legal system. What would Ofcom do if in this time a designated broadband provider rolled out uneconomic services and considered a claim relevant, would Ofcom fund the claim in the meantime? Would the operator have to wait for its funds? Would the operator end up getting no funds?

We understand Ofcom is proposing to consult on the funding mechanism in the summer. We therefore limit our comments at this time to the practical implications of Ofcom's proposal. We have assumed in line with past discussions that any funding mechanism that would be proposed on industry would be limited to operators, operating in the relevant fixed market. The mobile telecoms market has its own coverage issues; we have, and continue to invest significantly into reducing these issues.

Annex A – Frontier Investment and profitability report.

See separate report

Annex B - Ensuring transparency when network providers use your money to upgrade their infrastructure report.

See separate report

Vodafone Limited, Vodafone House, The Connection, Newbury, Berkshire, RG14 2FN, England. Registered in England No. 1471587