Approach to remedies

Response to Ofcom's consultation

June 2019

1. Executive summary

Sky supports Ofcom's and the government's goal of promoting investment in FTTP networks so that they are available to significantly more UK consumers than they are today. Large broadband retailers like Sky and their customers will play a critical role in determining whether investment in FTTP networks will be successful and full fibre services will be widespread and widely used. This is because any full fibre investment case depends on large volumes of subscribers moving quickly to the new network. If retailers cannot commit with confidence to move their customers to full fibre, then the success, scale and scope of these new networks is likely to be more limited.

However, there are significant obstacles to retailers committing to being anchor tenants on FTTP networks: UK consumers have low average willingness to pay for higher speeds or improved quality currently and there are substantial costs and disruption involved in connecting customers to full fibre. Therefore, broadband retailers require wholesale terms from new FTTP networks that allow them to create viable retail propositions that appeal to consumers enough for them to bear the disruption involved with moving to full fibre.

Broadly, Ofcom's proposed approach to remedies from 2021 is a sensible way of encouraging greater investment in FTTP, particularly by increasing network competition where that is possible. It is also appropriate to deregulate where competition becomes effective and sustainable (albeit, while potentially retaining regulated access to BT's ducts and poles) and, elsewhere, to focus (price) regulation on anchor products that are wholesale inputs into standard and superfast broadband services while allowing looser regulation of new, faster FTTP products (at least in the 70% of the UK which Ofcom considers to be potentially competitive). Given the risks involved in rolling out full fibre networks, it is justified to allow BT a 'fair bet' if it invests by not imposing cost-based price controls on faster FTTP services.

However, there are four problems with Ofcom's proposed approach that will harm consumers and retail competition without necessarily having a significant positive impact on investment in FTTP:

- anchor product price caps are likely to be too high;
- the anchor products themselves should be MPF and 80 Mb/s VULA (not MPF and 40 Mb/s VULA);
- there should not be a pricing premium for anchor products on FTTP; and

- minimum quality of service levels should improve significantly instead of being kept static from 2021.

Setting the price cap for anchor products too high would lead to significant consumer welfare loss and weaker retail competition without materially improving the prospects of FTTP investment in the UK. Frontier Economics, in a report prepared for Sky, estimates that in potentially competitive areas (70% of the UK) consumers could pay between £0.95bn and £1.42bn more over the five-year market review period than they would if Ofcom maintained cost-based price caps.

While Ofcom argues that there is a simple, positive relationship between anchor product prices and the revenues that can be earned from FTTP (and hence incentives to invest), the relationship is more complex. Ofcom's suggested approach may not induce materially more investment and roll out of full fibre networks (and in some respects could even undermine investment). [✂].

In potentially competitive areas, the strongest investment incentive will be on BT to defend itself from increased network competition from cable as a result of already planned upgrades to broadband speeds (including via moving to DOCSIS 3.1) and network expansion. If anything, allowing excessive regulated anchor product charges will dampen BT's incentives to invest to defend its position as its legacy network will earn higher profits.

Even for new entrant networks (altnets), higher anchor product prices under Ofcom's proposed approach would only have a marginal effect on their investment cases – attracting enough end users and post-entry pricing are far more important. The impact of anchor prices on UK FTTP investment cases is further diluted as there will not be a full pass-through of regulated charges to the retail prices of superfast broadband products and the consequential knock-on impact on ultrafast broadband retail prices will also weaken further over time. Clearly however, to the extent that excessive anchor product prices weaken competition from retailers such as Sky or drive increased fixed-to-mobile substitution, there would also be less scale available to altnets to underpin their investment cases.

In non-competitive areas, Ofcom is correct to propose to reduce anchor product prices closer to their costs if BT does not invest in FTTP. BT will have a weaker incentive to roll out full fibre here otherwise as there is no prospect of competition from either cable or altnets and returns on its copper network are high.

Ofcom is also proposing to allow BT to recover any FTTP investment costs through regulated charges in these non-competitive areas (via a regulatory asset base or "RAB"-style approach) but this approach requires significantly more 'fleshing out' before it is clear whether it is warranted. While, in principle, it may be appropriate for returns to

increase if BT does invest in FTTP in these areas, in some non-competitive areas where its costs are lowest for instance, BT's investment case may not depend on additional regulated returns. Elsewhere, where costs are highest and public subsidies are available, higher regulated charges are also unnecessary.

Even where RAB-based returns are warranted, Ofcom should consider whether it needs to adjust its approach to setting charges to reflect BT's lower levels of risk from its much stronger position in these non-competitive markets (compared to elsewhere). Ofcom's current costs of capital that it applies to BT are typically higher than those adopted by other regulators of companies with similarly strong market positions. There may be a case for Ofcom's future WACC estimate in non-competitive areas to be closer to the estimates of these other regulators.

Sky is also opposed to Ofcom's proposal to impose a *"modest price premium"* for anchor products on FTTP to reflect improved performance and quality. For the switchover to full fibre to be successful, the many DSL and FTTC subscribers who are entirely satisfied with their current service will, at the very least, require equivalent products at equivalent prices on FTTP. If retailers absorb the price premium instead, their incentives to migrate their customers to FTTP will also be reduced. In any event, while Ofcom has provided no evidence of the value of any improved performance and quality, it is likely that FTTP service quality will be relatively poor in the early years as the new products 'bed in'. Further, it is simply not credible that this 'modest' premium is critical to BT's full fibre investment case. In fact, charging the premium is more likely to have the opposite effect by undermining retailer and consumer willingness to upgrade to FTTP even further.

We also consider that the appropriate superfast anchor product by the start of the next market review period will not be 40 Mb/s VULA as proposed by Ofcom and will instead be 80 Mb/s. This is because nearly [✂]% of our broadband subscribers will be on 80 Mb/s or higher speed services and will grow significantly throughout the period and, industry-wide, the proportion of broadband subscribers on 80 Mb/s or above will be [✂].

We also disagree with Ofcom's proposed approach of maintaining static minimum service levels from 2021. Despite small improvements in service quality for consumers since Ofcom introduced minimum service levels, there is still a long way to go before they reach an acceptable level. While wide-scale FTTP and significant network competition may result in service improvements for some in the very long run, this is uncertain and would take many years to have a meaningful impact on most consumers. As FTTP is rolled out, consumers will remain heavily dependent on LLU and FTTC services. Therefore, Ofcom should materially increase the scope and level of minimum service levels instead of keeping them static.

In summary, excessive anchor product prices coupled with Ofcom's proposals to allow quality of service levels to remain static and to not increase in scope will result in considerable, unnecessary consumer welfare loss in the UK without materially impacting the roll out of FTTP (and even potentially undermining it). Therefore, Ofcom should ensure that anchor prices are constrained and not allowed to become excessive while continuing to require improvements in BT's service quality.

2. Introduction

Sky supports Ofcom's and the government's policy goal of promoting the widespread roll out of FTTP in the UK. Broadband already plays a key role in the economy and ensuring that more consumers and businesses have access to the superior speed, consistency and performance that full fibre will eventually provide is important for the UK's future international competitiveness and productivity.

FTTP is only currently available to 7% of UK premises[1]; far behind most major economies. Ofcom is therefore right to focus on policies aimed at increasing its availability. Any wide-scale FTTP roll out would take many years, be expensive and risky and take some time before it is profitable. As such, Ofcom is signalling its long term approach to policy-making in order to provide some certainty to investors and network builders; for example, through its focus on network builders being able to access BT's ducts and poles to install their own full fibre networks and through proposing looser or no price regulation of Openreach's faster FTTC and FTTP services.

However, whatever these policies, if consumers do not move to full fibre *en masse* and quickly then the success of the new networks will be more limited. This is a key determinant for any FTTP investment case. In this respect, there are considerable barriers. On average, consumers have a low willingness to pay for more speed and quality and the installation of a new fibre drop into a consumer's premises will be disruptive and costly.

Large retailers like Sky and their customers will help make FTTP a success

Given these conditions, the role of the large broadband retailers in driving consumers to these new networks will be important. Moving subscribers to FTTP will be a considerable undertaking that will involve large retailers deploying all their marketing and customer service expertise to encourage their customers to take up full fibre.

However, for Sky to commit to these new networks, it needs long term security of supply and wholesale prices and terms that account for the realities of relatively weak consumer demand today for FTTP. It is important therefore that Ofcom's remedies do not disincentivise broadband retailers and consumers from moving to FTTP because, if they do, roll out and adoption of these networks are likely to be hampered.

[1] Page 1, Ofcom 'Connected Nations: Spring Update' (May 2019).

3. Anchor product prices must be constrained in potentially competitive areas

In general, Ofcom's proposed approach to remedies appears to be a sensible way to encourage more investment in FTTP in the UK including, where potentially viable, through increased network competition. We support some deregulation where competition becomes effective and sustainable and, elsewhere, to focus (price) regulation on anchor products while allowing looser regulation of new, faster FTTP products in potentially competitive areas. Where rolling out full fibre networks entails some additional risk from high deployment costs and uncertain demand, BT should have a 'fair bet' if it invests by not being subject to cost-based price controls on faster FTTP services.

But Ofcom should be cautious about setting the price cap for anchor products too high because this will lead to significant consumer welfare loss and may weaken retail competition but it is less than clear that this would induce materially more investment and roll out of full fibre networks in the UK (and in some respects could undermine investment cases).

In Sky's view, broadband prices need to remain affordable as the market transitions to full fibre. Broadband services are not universally adopted and a large minority of consumers elect to take lower speed services, use mobile broadband only or not to take broadband services at all. This is particularly pronounced amongst the socio-economic groups that are most likely to gain from having a decent broadband connection. Maintaining and growing the appeal of fixed broadband amongst UK consumers will help underpin full fibre investment cases.

In potentially competitive areas (currently Ofcom considers this to be approximately 70% of the UK), Ofcom proposes to set the VULA charge control for BT's 'anchor' 40 Mb/s FTTC service at a level which keeps prices steady in real terms at 2021 levels. This departs from Ofcom's normal approach to charge controls of setting prices closer to BT's costs. This proposed approach means that the charge cap for this anchor service will progressively exceed BT's costs over time. Under the current charge control, the price cap for BT's 40 Mb/s service in 2021 will already be above BT's actual costs and, after accounting for increased volumes and further efficiencies, the gap between BT's costs and the price cap will widen further.

Ofcom proposes this approach because it considers that there is a simple, positive relationship between anchor product charge controls and investment in FTTP. In principle, higher charge controls will push up retail superfast broadband prices which in turn will raise ultrafast broadband prices and hence returns to new full fibre networks (thus

improving the investment case). In Ofcom's view, while consumers may pay more in the short term, they will benefit from more FTTP investment and network competition in the future.

While these potential future gains for UK consumers are uncertain and unquantified, it is clear that the costs of this policy to consumers in the medium term will be substantial. Frontier Economics estimate that consumers in potentially competitive areas could pay £0.95bn to £1.42bn more over the market review period than they would if Ofcom maintained cost-based prices.

However, our commercial experience and evidence prepared by Frontier Economics points to a relationship between anchor prices and investment in the UK that is far more complex than suggested by Ofcom. In practice, anchor VULA prices are unlikely to impact the level or speed of FTTP investment materially and, in fact, higher VULA prices may undermine investment by weakening retail competition and undermining investment cases (as large retailers, like Sky and TalkTalk, become less valuable to new networks as anchor tenants).

Overall, Ofcom's approach may mean that consumers pay significantly higher prices but may not receive any offsetting benefits of more FTTP investment. Therefore, we consider that regulated anchor product prices must be constrained and not excessive.

Ofcom's approach may mean that consumers pay an additional £0.95bn to £1.42bn over the market review period

Ofcom's approach involves a clear trade-off; in the short to medium term, anchor product prices will diverge materially from their underlying costs, but in the longer term it hopes that this will stimulate FTTP investment and competitive entry.

Under Ofcom's proposals consumers may pay £0.95-1.42bn more than they would if regulated prices were cost based

We asked Frontier Economics to estimate these medium term costs for consumers in potentially competitive areas. It found that under Ofcom's approach, by the end of the current charge control period (2021) the charge control for 40 Mb/s VULA will be around 24% above BT's costs (assuming the removal of the 'hypothetical on-going network' adjustment) and that if BT's actual costs fall by 20% between 2020/21 and 2025/26 then consumers would pay an additional £0.95bn to £1.42bn over the market review period.

While Ofcom does not quantify the short to medium term costs to consumers in its consultation, it considers that *"in the long term we consider that where there is scope for competitive entry this will deliver*

better outcomes for consumers than ongoing regulation of a monopoly provider, including stronger competition at the retail level." [2]

Excessive anchor prices may not materially impact the level or speed of FTTP investment

Despite this significant consumer welfare loss, Frontier Economics' assessment is that higher anchor prices may not stimulate materially more FTTP investment and entry in these areas and many consumers will pay higher prices for a long time without seeing any offsetting benefits.

The relationship between wholesale anchor prices and incentivising investment in new fibre networks in the UK is more complex than Ofcom suggests. Ofcom argues that higher anchor prices will mean that new entrants, who are likely to face higher costs than BT, will be able to compete with BT more easily and in turn, increased competition from new entrants will increase BT's incentive to invest in FTTP networks.[3]

We agree that, in principle, higher anchor prices could stimulate FTTP investment because these will lead to higher superfast broadband retail prices which may allow CPs to increase the price of ultrafast broadband services and this higher revenue will increase the investment returns on ultrafast networks. In practice though a UK FTTP investment case is far more sensitive to credible variations in other factors (such as penetration or cost per home passed). For some of these other factors, higher anchor product prices undermine the FTTP investment case and therefore the nature of the impact of anchor product prices on investment is not straightforward. We discuss these points further below.

Competing with cable is by far the main reason that BT will roll out FTTP

First, by far the greatest incentive for BT to invest in full fibre in potentially competitive areas comes from cable, which already offers significantly faster broadband speeds than BT (even before its planned upgrade to DOCSIS 3.1) and is currently expanding its footprint to c.60% through its Project Lightning programme. Competition from Virgin Media is more likely to incentivise BT to invest in FTTP than uncertain competition from new entrants. This is clearly shown by BT's current FTTP roll out ('Fibre Cities') which is focussed largely on cable areas.

Second, increasing charges even more above BT's costs will increase its returns on both its retail and wholesale superfast broadband services and will increase its incentive to sweat its existing copper network relative to investing in new FTTP networks (the so-called 'replacement effect').

[2] Paragraph 2.20(c), Ofcom 'Promoting competition and investment in fibre networks – Approach to remedies) (Consultation, March 2019) (consultation).
[3] Paragraphs 2.20(a)-(b), consultation.

Third, there will not be a full pass through from anchor product charges to ultrafast retail prices and hence returns to full fibre networks. As explained by Frontier Economics, not only will there not be full pass through from wholesale charges for anchor products into retail prices for superfast broadband but any knock on impact on the prices for ultrafast broadband depends on the degree to which consumers consider superfast and ultrafast broadband services to be close substitutes. While we expect that a significant proportion of wholesale anchor product charges would be passed through to retail superfast broadband prices (65% to 85%), there is mixed evidence about whether superfast and ultrafast broadband services are substitutable in the UK; particularly over the longer term.

Fourth, any positive impact of higher anchor product prices on a FTTP investment case (and ignoring any of the negative impacts on investment) will be not be large. Investing in FTTP networks is a long term decision with long (often 20 to 30 year) payback periods in the UK. Given this, the decision to invest will depend heavily on longer term returns based on the prices of ultrafast broadband services if competitive entry has occurred. These post-entry prices (which may reflect the lower competitive level of costs) are unlikely to be influenced by Ofcom's much shorter term proposal to increase the wholesale costs of superfast broadband services.

To assess this, we requested that Frontier Economics interrogate Sky's own modelling of a greenfield investment in an alternative FTTP network and it found that the anchor product price has only a marginal bearing on the business case. In particular, Frontier Economics found that even if anchor product prices are allowed to diverge from BT's costs by 20%, the impact on the internal rate of return ("IRR") and payback period is relatively modest. For instance, under Ofcom's proposed approach, Frontier Economics estimate that the IRR will increase by around 2.5% and the (undiscounted) payback period will fall by just one year. These movements would not make a large difference in whether Sky elected to proceed or not with the greenfield investment.

Excessive anchor product prices may weaken retail competition and further undermine investment cases

Excessive anchor product prices may undermine investment in FTTP by weakening some of the large broadband retailers in the UK that altnets are likely to depend on as anchor tenants. The potential weakening effect on retail competition from excessive BT charges was most evident from 2011 to 2017 when the price of 40 Mb/s VULA was not subject to a charge control and its price significantly exceeded its costs. During this time, BT Consumer's share of superfast broadband connections on the Openreach network far exceeded its competitors (often combined). Indeed, as Frontier Economics explain, between 2011/12 and 2016/17

when VULA was not charge controlled, BT's retail broadband market share grew by 9% from 37% to 46%.

While the introduction of the new charge control has begun to help alleviate this distortion (although Openreach's latest discount scheme has a much more beneficial impact) this will only be temporary if there is a further widening of the gap between BT's costs and its anchor product prices (as proposed by Ofcom).

This will not help new entrant networks who will depend on strong, independent retailers with large customer bases (like Sky) as anchor tenants because higher VULA prices would weaken the competitiveness of those retailers. It is essential for new fibre networks that they attract large volumes of end users quickly to generate the cash flows that are so important to the success of their investments – something that is only possible if they sign up large retailers as anchor tenants.[4]

In practice, for scale FTTP deployments there are only two main independent retailers that could credibly be anchor tenants to altnets – Sky and TalkTalk. Together BT and Virgin Media (who are both vertically integrated and unlikely to use other networks) make up approximately 54% of the retail broadband market. Therefore, only around 40% of retail broadband subscribers are currently contestable to new entrant networks. Further, TalkTalk [✂] focusses on the 'value' segment of the broadband market which may restrict its ability to migrate customers at scale to FTTP.

40% penetration for an altnet FTTP network is already quite low for a viable investment case in the UK. If higher anchor product prices lead to operators like Sky and TalkTalk losing market share this could weaken the investment case further.

Roll out of FTTP is most likely to succeed if wholesale prices incentivise retail CPs to migrate customers *en masse* and at pace

There is a risk therefore that raising the prices of existing superfast services could merely drive subscribers to cheaper or more competitive alternatives – such as cable (which already offers faster speeds), ADSL or mobile – and throttle demand for faster services on FTTP networks. On the other hand, the best prospects for FTTP investment stem from FTTP networks offering attractive wholesale access rates that provide retailers and their customers with the appropriate incentives to adopt the new technology *en masse* quickly.

Rather than allowing anchor product prices (and, by association, retail FTTP prices) to drift upward, Ofcom should keep prices closer to cost

[4] In its recent Q4 2018/19 announcements, BT's CEO noted that having BTC as an Openreach anchor tenant underpins its ambition to rollout to 15 million homes by 2025 because it provides greater demand certainty.

because this will incentivise FTTP networks to set prices at a level that encourages CPs to migrate customers in a commercially viable way. This approach would better address the significant constraints on CPs to migrate customers to FTTP.

Consumers currently have a low average willingness to pay more for faster speeds but migrating to fibre is costly and disruptive

In our view, there is little scope for revenue growth as the market moves to FTTP. UK consumers demonstrate a low average willingness to pay more for faster speeds, while UK telecoms revenue continues to decline. For example, Ofcom's 2018 'Communications Market Report' found that average monthly household telecoms spend is largely flat (around £87 per month) and that both reported wholesale and retail revenues decreased slightly between 2016 and 2017.[5]

Further, at least in the early years of deployment, FTTP may not offer significant service benefits to customers (particularly as fault rates are likely to be higher and provisioning slower as new processes and expertise bed in). In any event, consumers will not have a significant average willingness to pay more for improved service quality. In addition, the disruption associated with migrating customers (such as requiring that a customer take time off work to attend an engineer visit and, for example, having their front garden dug up) may dissuade customers from migrating at all.

[5] Sector overview table, Ofcom 'Communications Market Report: 2018' (interactive report).

4. Anchor product prices in non-competitive areas should be reduced to BT's actual costs

In non-competitive areas, Ofcom proposes to reduce anchor product prices (by removing the hypothetical ongoing network adjustment) but allow them to rise if BT invests in FTTP in these areas. This is effectively a utility-style approach where any investments in FTTP are treated as a pool of costs that form part of a RAB that can be recovered across multiple services.

Ofcom is correct to consider a different approach in areas of the UK where the prospect of network competition is highly unlikely. Here, the absence of any possible network competition means that BT is the only network operator likely to deploy full fibre (other than any publicly funded FTTP roll out awards won by other network operators). Therefore, Ofcom's remedies should not be focussed on supporting entry by altnets but on directly incentivising BT to invest more.

Without the prospect of competitive entry by altnets and if anchor product prices were maintained at the level proposed by Ofcom in these potentially competitive areas, BT would not have an incentive to invest in full fibre. Given the high profits it currently earns from its copper network, it would have a strong incentive to continue to sweat its legacy network. This is true whether anchor product prices are based on the costs of a 'reasonably efficient operator' (as proposed by Ofcom in potentially competitive areas) or on a 'hypothetical ongoing BT network' (the commonly used approach by Ofcom to setting previous charge controls).

In order to overcome this disincentive, Ofcom is right to consider setting anchor product charge controls based on BT's actual costs (including removing any upward cost adjustment to reflect a hypothetical ongoing network). Ensuring BT's returns on its legacy network are reduced to 'normal' levels will remove the distorting disincentive to invest in full fibre.

Before considering what other measures may be necessary, we think it is appropriate for Ofcom to assess properly the effect of lowering BT's copper returns on its full fibre investment incentives in non-competitive areas. In some areas for example it may not be necessary for Ofcom to also adopt a RAB-style approach to further support FTTP investment by BT. Further, given the national retail pricing policies of the UK's broadband providers, retail prices may not fall in these areas by as much as wholesale costs (if at all) – thus maintaining potential revenues to be earnt from new network investment.

Ofcom has proposed that, should BT invest in FTTP in these areas, then charge controls should be allowed to rise in order for BT to recover its

investment costs – through the 'RAB-style' approach. While in principle, it is appropriate for Ofcom to consider whether additional steps to incentivise investment by BT are justified, it is important that any approach to full fibre cost recovery in non-competitive areas is not 'open-ended' and is subject to appropriate scrutiny for the following reasons:

- If BT was guaranteed to recover its FTTP investment costs through charge controls, it could roll out even in the most (otherwise) uneconomic areas. This could lead to large increases in retail broadband prices for consumers; either nationally or in the 30% of the UK that Ofcom categorises at non-competitive. This may not be proportionate and may encourage 'gold-plating' of its FTTP network by BT.

- There is a risk that, while all consumers in the non-competitive areas will pay materially higher broadband prices, far fewer will be passed by the new FTTP network. A transfer of welfare from the many to the few in this way may not be appropriate.

A proper cost-benefit assessment encompassing these factors could mean that it is not appropriate to allow anchor product prices to rise in order to allow BT to recover its investment costs through these charges throughout the non-competitive area.

If on proper assessment Ofcom elects to proceed with a RAB-style approach in these areas, the likelihood of certain consumers paying higher prices to fund a wider roll out of FTTP by BT without directly benefiting from that roll out places an even greater onus on Ofcom to ensure that BT's FTTP returns are not excessive. In this respect, there are two important considerations:

- BT has an effective monopoly in these areas (indeed, the RAB-style approach has some similarities to the approach taken by 'pure' monopoly regulators) which would be further reinforced by Ofcom's proposed approach to lower anchor product prices (as entry by others may be made more difficult). As such, it is appropriate for Ofcom to consider other features of regulation by these other regulators when it comes to setting BT's prices in these areas – for instance, by lowering the relevant cost of capital further to reflect a relatively lower level of risk.

- The RAB-style approach that Ofcom suggests is likely to be complicated and difficult to implement and monitor. This opens the door to regulatory gaming and the exploitation of the information asymmetry between BT and Ofcom. This is something which industry is all too familiar with over many years in relation to BT's regulatory financial statements. Ofcom will need to be well-resourced and thorough if it wishes to minimise the risks to consumers that moving to a RAB model presents.

Sky supports reducing significantly BT's high returns on copper services in non-competitive areas so that the disincentive on BT to roll out FTTP is removed. In principle, it may also be appropriate to allow BT to recover some FTTP investment costs through charge controls for anchor products, but it is critical that any fibre returns are proportionate, given BT's unassailable monopoly in these areas and the risk that many consumers may pay higher VULA prices without experiencing any offsetting benefit in terms of FTTP being available where they live.

5. Where there is competition it is right to deregulate while maintaining regulated access to BT's ducts and poles if necessary

Ofcom proposes that in competitive areas it would not impose regulation. Sky supports removing regulation in areas of the UK where there is effective and sustainable network competition because this should drive good outcomes for consumers in terms of pricing, investment and innovation. Regulation should only be in place if it is necessary and should be appropriate and proportionate to the level of competition in the market.

However, where effective network competition is only possible as a result of regulated access to BT's duct and pole network, then Ofcom must consider maintaining this remedy on BT in these areas.

6. Anchor products

There are two further aspects of Ofcom's proposed approach to anchor product remedies that Sky considers to be wrong. First, we do not consider that it is either justified or appropriate to charge a premium for anchor products provided over FTTP and, second, we think the anchor products should be MPF and 80 Mb/s VULA (as opposed to 40 Mb/s VULA).

An anchor premium on FTTP is unjustified and inappropriate

In areas where BT is deploying a fibre network, Ofcom sets out some proposals for how the transition from copper to fibre should be managed and how the focus of its regulation should shift. Ofcom proposes that it will regulate BT's 'anchor' FTTC and FTTP VULA products in parallel for at least two years as the transition from copper to fibre happens, and then once the two-year period has lapsed it would switch to regulating only fibre-based products.

In potentially competitive areas, this means that Ofcom will initially charge control BT's anchor copper and fibre products (which Ofcom suggests should be 40 Mb/s FTTC and FTTP) before shifting to charge controlling only BT's anchor fibre product. However, Ofcom proposes that there should be a *"moderately higher charge"* [6] (or premium) for the 40 Mb/s FTTP anchor product.

We consider that this proposition is fundamentally flawed and should not be implemented.

One of the key benefits to both Openreach, and the UK more generally, of investing in FTTP is the opportunity to move all customers onto new fibre networks, and to decommission the old copper networks, i.e., to undertake a switchover from copper to full fibre.

Many customers will be happy with their existing services, so retailers must be able to offer new full fibre products at equivalent prices

It is inevitable that in any area there will be a significant proportion of households who are entirely satisfied with their existing DSL or FTTC broadband service and have no desire to move to an FTTP-based service. For such customers, it will be imperative that there are equivalent FTTP-based services to their existing service, which are priced equivalently. This will enable retailers to assure such customers that they will not need to pay any more after switching (or being switched) to the new network.

A proposal that the 'baseline' FTTP-based anchor product should have a higher regulated wholesale charge than the equivalent FTTC-based product would, therefore, comprise a significant impediment to switchover in the UK. The only way that retailers could persuade these

[6] Paragraph 5.20, consultation.

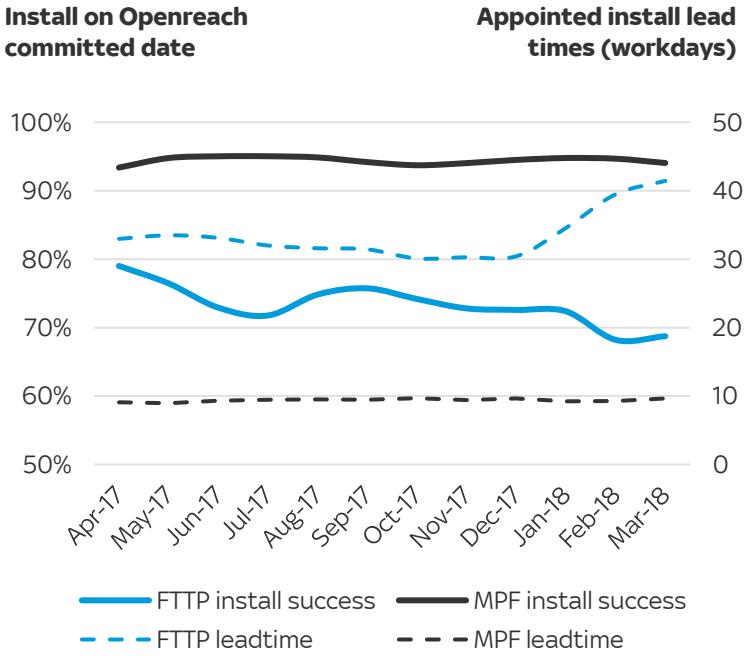
customers to switch would be to absorb the higher wholesale charges that would need to be paid on customers on FTTP-based anchor products. This additional cost to retailers, like Sky, is likely to disincentivise moving all customers onto new fibre networks. We consider that Ofcom should not be considering creating further impediments to full fibre switchover.

We note that Ofcom has asserted that there would be *"cost savings in the value chain"*[7] which, if true, might potentially offset some or all of the additional cost of higher wholesale charges. However, Ofcom's assertion of such cost savings is unparticularised and unevidenced. We are highly sceptical that there would be any such cost savings to retailers (particularly having regard to the substantial cost of switching customers that retailers are likely to have to incur), or that, if such savings emerge, that they would offset the amount of higher wholesale charges associated with customers on FTTP anchor products.

On the contrary, we consider that there are reasons to believe that the cost savings to retailers from FTTP in the early years of deployment are likely to be modest, or indeed result in higher costs to retailers:

- First, Openreach's provisioning quality of service for FTTP is much worse than for copper-based installations. This worsens the customer journey and is likely to create additional costs for retailers in the short-to-medium term.

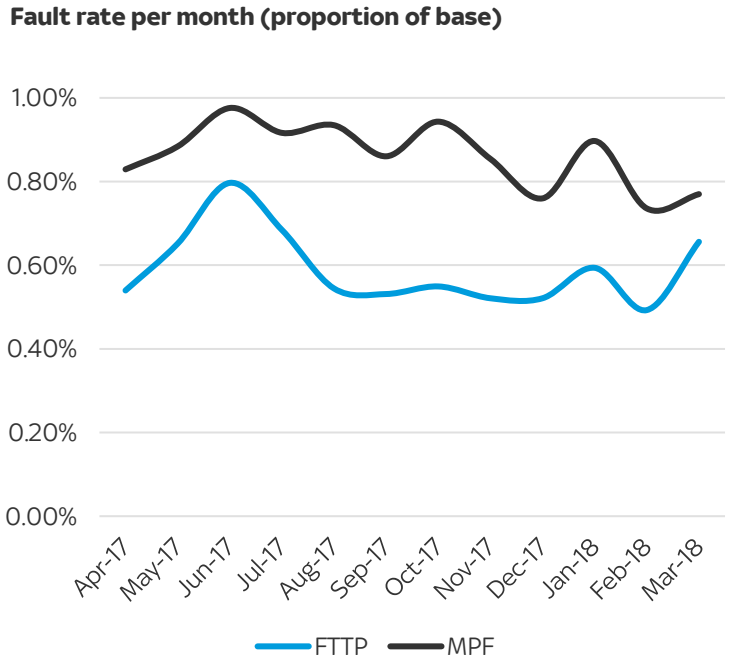
Figure 1: Openreach provisioning on MPF and FTTP



[7] Paragraph 5.19, consultation.

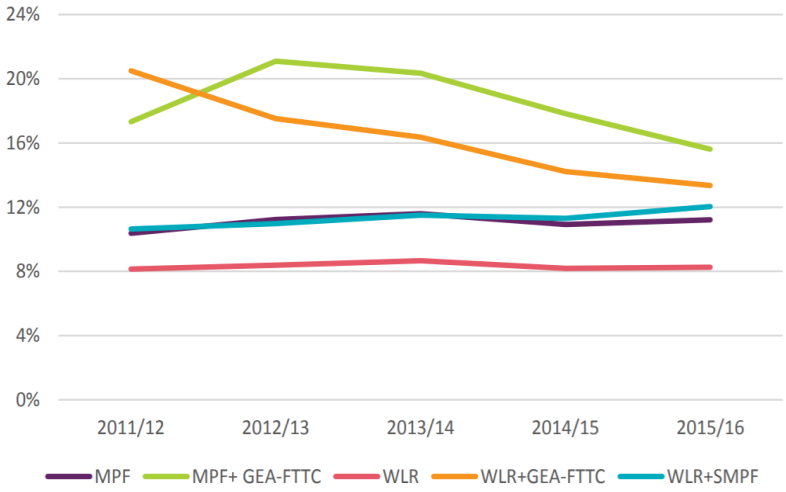
- Second, while Openreach's fault rate for FTTP is better than copper-based products, it is still much higher than we would expect.

Figure 2: Openreach fault rate on MPF and FTTP



- This is unsurprising. As Ofcom acknowledged in the last Wholesale Local Access market review, in the early stages of deploying a new technology quality of service is often worse and fault rates can be higher *"as new processes and expertise are bedding in"* (see below).[8] This was certainly our experience in relation to BT's deployment of FTTC VULA in 2010/11 and is likely to be the case for FTTP deployment now.

Figure 3: Annual Openreach fault rates for each service type



[8] Paragraph 4.25 and figure 4.3, Ofcom 'Quality of Service for WLR, MPF and GEA' (Consultation, March 2017).

Notwithstanding this fundamental point, Ofcom's reasons for proposing that there should be higher charges for FTTP-based anchor products are set out extremely briefly (in just two paragraphs of the consultation) and without any supporting evidence. We consider that such an approach, given the potential significant impact of this proposal, is manifestly inadequate.

Ofcom asserts that:

- in practice the same speed broadband services delivered via FTTP and FTTC will not be the same, and therefore should have different wholesale charges; and

- if wholesale charges were set equivalently between the two services, this *"may undermine incentives to invest in fibre"*[9].

In relation to the first of these, Ofcom asserts that (i) the speed of the FTTP product may be higher, and more stable, and (ii) the FTTP product will be less prone to faults and therefore more reliable. To the extent that these assertions are demonstrable, we do not consider that they would be sufficiently attractive to the types of consumers attracted to anchor products to enable any price premium to be charged at the retail level.

In relation to the second of these assertions, we consider that it is wholly implausible that the absence of a *"moderately higher"*[10] wholesale charge for anchor FTTP products could undermine incentives to invest in fibre to any discernible or meaningful extent in the UK.

The appropriate anchor product is 80 Mb/s VULA

In potentially competitive areas, Ofcom must choose appropriate anchor products based on the strength of the constraint those products place on superfast and ultrafast broadband services. Ofcom proposes to set a charge control on 40 Mb/s VULA but does not provide any evidence as to why it considers that this is the appropriate anchor and states that *"it recognise*[s] *that the strength of the constraint provided by the 40/10 product may diminish over the control period, but this will happen gradually, allowing time for competitive investment to emerge and add to the competition already provided by Virgin"* [11] (emphasis added).

However, in Sky's view whatever evidence there is points to 80 Mb/s VULA being the appropriate anchor product. Sky [✂] has over [✂]% of its base on superfast broadband with around [✂] of these on 80 Mb/s or above. We expect that by 2021 approximately [✂]% of our

[9] Paragraph 5.20, consultation.
[10] Paragraph 5.20, consultation.
[11] Paragraph 2.20(c), consultation.

broadband base will be on superfast broadband or above and, of that, over [✂]% will be on 80 Mb/s or higher.

We expect other major broadband providers such as BT and Virgin Media will have [✂] of their subscriber bases on 80 Mb/s or above. In fact, Ofcom recently found that around two-thirds of UK home broadband connections were superfast products and that the average actual home broadband download speed in 2019 was now over 50 Mb/s.[12] This is set to grow even further by 2021.

Overall therefore, we consider that Ofcom should reset the anchor product at 80 Mb/s. At the very least, it needs to demonstrate that 40 Mb/s places a sufficient constraint on superfast and ultrafast broadband services over the course of the entire market review period.

[12] Figures 2 and 3, Ofcom 'UK Home Broadband Performance: The performance of fixed-line broadband delivered to UK residential consumers' (May 2019).

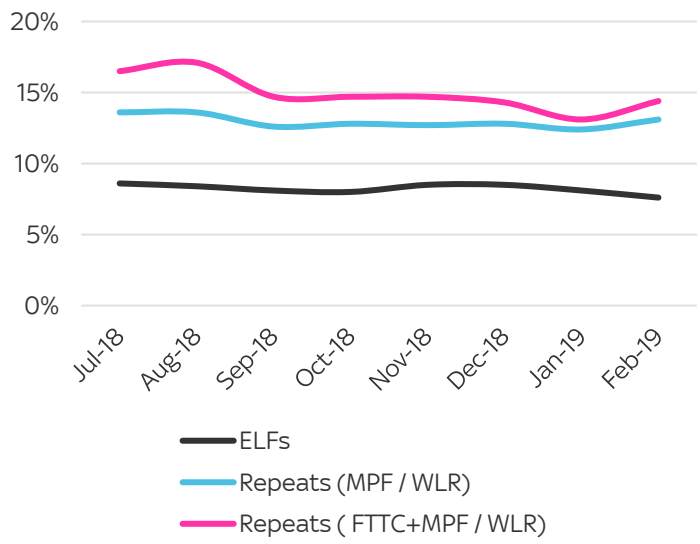
7. Minimum quality of service levels should continue to improve and widen in scope

Sky consistently delivers the best fixed communications and pay TV customer service in the UK. This leads to good outcomes for customers and is an important way to differentiate ourselves from our competitors. For the third year running, Ofcom's recent 'Comparing Service Quality' report found that Sky had the fewest complaints for broadband and that *"Sky customers were less likely to have a reason to complain"* [13] than customers of other CPs.

However, not everything in the broadband supply chain is within our direct control and this can limit the scope for Sky to continue to deliver service quality improvements to our customers. Instead, as an access seeker, the service quality that we can deliver is directly related to BT's quality of service performance. We agree that Ofcom needs to continue to regulate BT's quality of service by imposing minimum service levels across the range of regulated products where it finds that BT has SMP.

Openreach's service quality has only been gradually improving over recent years since Ofcom introduced modest minimum service levels but this was after many years of underinvestment and very low service quality. There is much more improvement necessary; as shown below around one in twelve installations result in an early life failure and repeat fault rates for all copper-based services remain unacceptably high.

Figure 4: Openreach 'Early Life Failures' & repeat fault rates



[13] Pages 1 and 4, Ofcom 'Choosing the best broadband, mobile and landline provider: Comparing Service Quality' (April 2019).

We agree with Ofcom's position in the last Wholesale Local Access market review that *"[o]ne of the consequences of Openreach's SMP … is that BT might not have the incentives to provide the quality of service that telecoms providers and customers require. Inadequate QoS delivered by BT has the potential to undermine the effective functioning of the network access remedy, to the detriment of both customers and downstream competition."* [14] Therefore, we are disappointed on behalf of our customers that Ofcom is proposing to keep minimum service levels static from 2021 onwards.

We do not agree with Ofcom's proposals to keep minimum service levels constant from 2021 and to decrease the scope of products to which they are applied. Consumers over the next decade or more as FTTP is rolled out in UK will be highly dependent on the full suite of Openreach services – LLU, FTTC and FTTP – and service levels on these still fall a long way short of expectations. It is not desirable during this time to lose focus on driving much needed improvements to provisioning and assurance performance by not increasing the scope of minimum service levels or improving their level.

Further, minimum service levels should not be imposed only on the FTTP anchor product when BT has switched from copper to fibre and Ofcom shifts its charge control to fibre services. To protect adequately consumers that use FTTP, Ofcom should impose equivalent and improving service standards on both the FTTC and FTTP anchor products. Otherwise BT may have an incentive to prioritise its resources in a way that deteriorates quality of service on FTTP until regulation on the anchor product has transitioned from copper to fibre.

As the market moves to FTTP over the next decade or more, it is essential that consumers retain confidence in the broadband market, its suppliers and network operators. This will be a period of considerable disruption and costs to consumers as they are connected to new networks. Therefore, consumers will require affordable and attractive products and will expect the timely delivery of broadband services and a speedy resolution of any faults. Ofcom's proposals for minimum service levels and anchor prices risk falling some way short of these consumer requirements.

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[14] Paragraph 8.12, Ofcom 'Wholesale Local Access Market Review' (Statement, March 2018).