

CityFibre response to the further WFTMR Consultation on Certain PIA Remedies

Non-confidential

11 December 2020

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1 Executive Summary

- 1.1 This document comprises our formal response to Ofcom's consultation entitled 'Wholesale Fixed Telecoms Market Review 2021-26: Further consultation on certain proposed remedies', published on 6 November 2020.¹
- 1.2 Ofcom has revised proposals for (among other things) PIA pricing. A key basis for the new proposals revolves around Openreach's claims that there is an immediate need to increase PIA prices to reflect increased utilisation, on the assumption that copper will soon be removed from Openreach's ducts. We consider this argument to be without basis, given that Openreach has repeatedly denied requests from CPs to remove redundant copper to relieve congestion, and in doing so indicated that copper will not be removed for some time. CityFibre does not understand how both of these statements can be true.
- 1.3 Notwithstanding this, we set out in this submission our views that Ofcom is entirely incorrect to value PIA assets on the basis of current costs (i.e. CCA). While such an approach may be appropriate when assessing appropriate cost-based charges for active wholesale services,² it is not appropriate for PIA given Ofcom has clearly stated that it sees no benefit in third parties duplicating ducts and poles.
- 1.4 Given this, and that many PIA assets are heavily depreciated, setting PIA charges on the basis of current costs risks significant over-recovery by Openreach. We consider therefore that Ofcom must implement a PIA RAB in order to ensure that going forward, Openreach is unable to continue to over recover on PIA assets.
- 1.5 We have modelled three approaches that Ofcom could use for a PIA RAB. This modelling shows that, with the single exception of 3+ bore duct, Ofcom's proposals to increase PIA prices over the coming market review period are entirely inappropriate.
- 1.6 While we accept that there may now be insufficient time for Ofcom to undertake the necessary analysis (i.e. to create a PIA RAB) ahead of the 2021 WFTMR Statement, we consider that Ofcom must as soon as possible begin such work. On the basis of our own initial analysis, we estimate that once PIA assets are valued appropriately, the price caps for PIA services fall very substantially.
- 1.7 In the meantime, we consider that Ofcom could implement a 'holding pattern' to ensure that going forward, over-recovery by Openreach on PIA assets is minimised. On the basis of what we set out below, this could be achieved by implementing CPI-CPI and or CPI-0 price caps, for certain PIA products.
- 1.8 This 'holding pattern' could be updated as soon as Ofcom have completed its review of the appropriate PIA asset valuations and can accurately determine what PIA price caps should be in place.

¹ https://www.ofcom.org.uk/data/assets/pdf_file/0023/206960/wftmr-further-consultation-proposed-remedies.pdf

² Where prices are set to replicate those that would be charged by an efficient operator of a modern equivalent network to facilitate a "build or buy" decision.

1.9 The remainder of this document is structured as follows:

- **Section 2:** sets out an introduction, including our assessment as to why valuing PIA assets on the basis of CCA is not appropriate and therefore the need for a RAB.
- **Section 3:** sets out our views on how a PIA RAB can be implemented.
- **Section 4:** sets out our views on other matters raised in the consultation.
- **Annex 1:** evidence of BT returns being in excess of WACC in regulated markets.
- **Annex 2:** (attached separately) our workings showing the indicative values for PIA prices using the RAB approach.

2 Introduction

2.1 The introduction of regulated PIA (10 years ago) marked a fundamental shift in the UK telecommunications market, by allowing operators to more efficiently deploy new networks, by re-using Openreach's existing physical infrastructure. As with any regulated product however, the key to making it usable and useful to third parties comes down to the terms of access and price.

2.1 Valuing PIA assets on the basis of CCA is not appropriate

2.2 Since the late 1990s, regulated prices of BT's wholesale services have been set on the basis of the current costs of the network (often called Current Cost Accounting, or CCA), as opposed to the actually incurred (i.e. historic) costs (often called Historic Cost Accounting, or HCA).

2.3 This is usually done with the intention of providing the right 'build vs buy' incentives for third parties. In other words, a price for wholesale access that is too low would undermine incentives for third parties to build themselves (since it would make more sense for them to just buy access instead). This would risk an un-ending reliance on wholesale access by third parties. Conversely a price for wholesale access that is too high will deter people from buying it, undermining the regulatory intervention to make it available in the first place.

2.4 An issue of using a current cost approach however is that when prices are set in excess of current costs, Openreach will over recover its investment over the lifetime of the assets used. This may happen for example where Openreach has been allowed to keep prices above costs to encourage migration away from a legacy product, such as wholesale line rental, or where prices were kept high to encourage new market entry which emerged more slowly than anticipated, for example in Ethernet services. However, as noted above, in some cases the current costs of the assets is still used for future pricing despite the over recovery as this may be a 'price worth paying' in order to promote the rights 'build or buy' incentives for third parties.

2.5 But for PIA, Ofcom has already stated that it does not consider it efficient for third parties to duplicate ducts and poles. Instead Ofcom has established PIA as a central pillar of its overarching strategy to promote competition and investment. Given this, there is no reason for Ofcom to adopt an approach to pricing PIA on the basis of current costs in order to mitigate the risk of encouraging 'buy' over 'build'.

2.6 As a result, Ofcom should adopt an approach to price setting based on ensuring that Openreach is able to recover its efficiently incurred costs (as well as reasonable return on their investments), but no more. This can be achieved by regulating prices using a regulatory asset base (RAB), as has been used by other UK regulators (e.g. in electricity, gas, water and aviation) for many years, and which was in fact previously considered by Ofcom in regard to active wholesale services in Area 3.

2.2 The need for a PIA regulatory asset base (RAB)

2.7 In our supplemental response to the January 2020 WFTMR Consultation, we noted that while Ofcom's proposed approach to valuing PIA assets has many characteristics of a RAB approach, it departs from the RAB methodology in a number of key aspects, including by not using the book value from Openreach's regulatory financial statements (RFS) as the opening RAB balance.³

³ [CityFibre further response to the WFTMR Consultation: PIA Remedies 27 August 2020](#)

- 2.8 Although Ofcom is now reconsulting only on the issue of allocation percentages for dual and multi-bore duct and how these may move over time, particularly in the context of copper decommissioning, we consider that the problems that Ofcom has noted and is trying to resolve, are caused by the inappropriate calculation of the RAB basis. Rather than adopting arbitrary allocation percentages in the short term, we believe Ofcom could better address these issues by resolving the underlying problems with the RAB calculation.
- 2.9 We recognise that this could be a material piece of work for Ofcom to undertake. However, we firmly believe that this must be undertaken in order to ensure that PIA prices are set at appropriate levels.
- 2.10 Under a RAB approach, the evolution of prices will depend on the specific RAB approach adopted. We have identified three approaches that Ofcom could use and have thereafter modelled each to understand what the different price paths over time would be for each. This analysis is set out from paragraph 3.35 onward.
- 2.11 This modelling shows that, with the single exception of 3+ bore duct, Ofcom's proposals to increase PIA prices over the coming market review period are entirely inappropriate.
- 2.12 For example, we find that for joint boxes, manholes and lead-in duct, all RAB approaches we have modelled result in prices which are significantly below a 'flat' (i.e. CPI-CPI) line, across the entire period modelled (i.e. up to 2030/31).
- 2.13 For single and 2 bore spine we observe that some RAB approaches result in prices below the 'flat' (CPI-CPI) line, with some approaches resulting in something broadly equal to CPI-CPI. In all scenarios we observe that the RAB approaches were below the CPI-0 (flat real) price line.
- 2.14 While we accept that there may now be insufficient time for Ofcom to undertake the necessary analysis (i.e. to create a PIA RAB) ahead of the 2021 WFTMR Statement, we consider that Ofcom must as soon as possible begin such work. On the basis of our own initial analysis, we estimate that once PIA assets are valued appropriately, the price caps for PIA services fall very substantially.
- 2.15 In the meantime we consider that Ofcom could implement a 'holding pattern' to ensure that going forward, over-recovery by Openreach on PIA assets is minimised. On the basis of what we set out above, this could be achieved by implementing CPI-CPI and or CPI-0 price caps, for certain PIA products.
- 2.16 Notwithstanding this, we note that even under the assumptions currently adopted by Ofcom regarding PIA asset valuation, the arguments advanced by Openreach which suggest the need for increasing PIA prices is without basis. Indeed, during the course of PIA industry meetings Communication Providers (CPs) have proposed copper removal as a means of relieving congestion in the network and this has been rejected by Openreach on the grounds that they have no plans to remove redundant copper in the short to medium term. The argument therefore that imminent copper removal will impact duct utilisation is entirely without basis as far as we can see.

2.3 A RAB would resolve a fundamental issue with Ofcom's current proposals

- 2.17 Ofcom is reconsulting on the pricing of 2-bore and mutli-bore spine duct by considering the occupancy levels that should be assumed for that duct. This approach however is undermined by a fundamental misconception: that a substantial percentage of Openreach's previous investment in duct has not yet been recovered and must therefore be recovered through future pricing.
- 2.18 By addressing the problems with a RAB, Ofcom would no longer be faced with the measurement of exact duct occupancy levels, and there would be no price instability over time. The entire basis of the WFTMR as we understand it is to incentivise infrastructure investment and network build by reducing levels of price regulation on active services.
- 2.19 Altnet build is supported by the availability of access to PIA infrastructure, at fair prices. The proposals in this latest consultation contain price increases of up to 30% for that passive infrastructure and will make it significantly more difficult for network builders to help Ofcom deliver its vision.
- 2.20 Ofcom proposes to increase the PIA prices over the review period because it now estimates that the utilisation of Openreach's duct will be less than previously thought. This must have implications for the wider policy aspects of Ofcom's modelling. We are aware that Ofcom's calculations that estimated the excessive returns Openreach would enjoy included assumptions regarding future volume forecasts and their associated unit cost impacts. If these price increases reduce the forecast use of PIA in the future, it follows that the use of Openreach's active products will increase.
- 2.21 It cannot remain true that active service price regulation can be weakened due to greater use of PIA if Ofcom is at the same time justifying substantial price increases for PIA on the basis that usage will not in fact be as high as hoped. Indeed, price increases on PIA may cause these lower forecasts to become a self-fulfilling prophecy. This approach seems to us fundamentally at odds with Ofcom's strategic shift to promote infrastructure competition.

3 Implementing a RAB approach to PIA

3.1 In this section we set out how Ofcom can implement a PIA RAB as well as the benefits of doing so. It is structured as follows:

- **Section 3.1:** the legal and regulatory framework for implementing a PIA RAB;
- **Section 3.2:** the advantages of using a RAB approach; and
- **Section 3.3:** how the RAB can be calculated and our estimate of how the price of duct services would be set as a result.

3.1 Legal and Regulatory framework

3.2 In this section we set out the legal and regulatory framework for implementing a RAB approach for PIA.

Ofcom's objectives for PIA pricing

3.3 Ofcom set out its approach to PIA pricing in its earlier consultation document.

"In developing the proposed charge controls, we have had regard to our overarching legal duties. ... we propose to exercise our discretion in setting these controls in favour of an approach that is aimed at supporting investment in fibre networks.

Our proposals seek to do this by ensuring that:

- a) Openreach has the opportunity to recover efficiently incurred costs; and*
- b) a level playing field exists between Openreach and competing telecoms providers that make use of PIA to provide downstream products.*

Establishing a level playing field between Openreach and rival networks would be important for ensuring that BT and its competitors have appropriate conditions to support their investments. In addition, providing Openreach with the opportunity to recover its efficiently incurred costs would support Openreach's incentives to invest more generally."⁴

3.4 Ofcom's objectives as set out above appear to be supported by all stakeholders. However, as we set out above, its existing proposals do not create a level playing field nor meet its objectives e.g. to ensure against unreasonable over-recovery.

EC Recommendation on broadband costing methodologies

3.5 Ofcom noted in the WFTMR Consultation:

"Consistent with our duties, we are taking due account of any applicable European Commission (EC) recommendations or guidelines."⁵

3.6 The EC issued recommendations on costing methodologies for use in broadband in 2013. The recommendation sets out the appropriate methodologies to use in modelling the costs of physical infrastructure, distinguishes these from the methodologies applicable to other assets

⁴ [WFTMR Consultation, Volume 4, Paragraphs 5.8 to 5.10](#)

⁵ [WFTMR Consultation, Volume 1, Paragraph 2.5](#)

used by telecommunications operators and explains why they are appropriate (our emphasis added).⁶

*Unlike assets such as the technical equipment and the transmission medium (for example fibre), **civil engineering assets** (for example ducts, trenches and poles) **are assets that are unlikely to be replicated**. Technological change and the level of competition and retail demand are not expected to allow alternative operators to deploy a parallel civil engineering infrastructure, **at least where the legacy civil engineering infrastructure assets can be reused for deploying an NGA network**.*

*In the recommended costing methodology the Regulatory Asset Base (RAB) corresponding to the reusable legacy civil engineering assets **is valued at current costs, taking account of ... the costs already recovered by the regulated SMP operator**. This approach sends efficient market entry signals for build or buy decisions and avoids the risk of a cost over-recovery for reusable legacy civil infrastructure. **An over-recovery of costs would not be justified** to ensure efficient entry and preserve the incentives to invest because the build option is not economically feasible for this asset category.⁷ [Emphasis added]*

- 3.7 Under this RAB approach therefore the current cost of the asset must take account of the costs already recovered by the SMP operator. This contrasts with the approach used in modelling costs for other assets, which should model the “*incremental capital (including sunk) and operating costs borne by a hypothetically efficient operator ... and adds a mark-up for strict recovery of common costs*”⁸

Ofcom’s approach to the cost of duct

- 3.8 We cover below our assessment of Ofcom’s approach to duct valuation. We note that we have not undertaken an assessment of pole asset costs in this submission however consider that the approach we set out below for ducts should also apply to poles, in particular the opening RAB base for poles should be set be at or near zero.
- 3.9 Ofcom has for many years taken a hybrid approach to the valuation of duct. The opening RAB for duct and copper cables as at 31 March 2005 was adjusted downward from depreciated, indexed historic costs to adjust for the over recovery of a revaluation that had taken place in 1997.⁹ At that time it was expected that the recorded depreciation and the amounts recovered would be equal in all future years and hence no further RAB adjustment would be required in future.
- 3.10 Ofcom recognised that removing the potential to over recover an asset in future does not impact economic incentives significantly. It noted that:

“The possibility of expropriating assets is a matter that Ofcom takes very seriously. Ofcom agrees that clawing back profits which are due to unanticipated efficiency gains would damage incentives to increase efficiency. However, the opportunity for over-recovery resulting from the 1997 revaluation to CCA did not result from any efficiency on the part of

⁶ [Commission Recommendation of 11 September 2013 on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment \(2013/466/EU\) \(“NGA costing recommendation”\)](#)

⁷ NGA Costing Recommendation, Recital (34) and (35)

⁸ NGA Costing Recommendation, Recital (29)

⁹ [Ofcom Final Statement “Valuing Copper Access” 18 August 2005](#)

BT, Ofcom believes that removing the opportunity for over-recovery in future should have minimal effect on economic incentives.”¹⁰

3.11 Although this “RAV adjustment” made in 2005 has remained in place ever since for both Regulatory Financial Statements (RFS) and pricing models, no subsequent attempts to adjust the regulatory values for over recovery have been made. In effect, Ofcom has been using a “part RAB” rather than a “full RAB” approach. As we note above this may indeed be the correct approach for pricing active services, but it is not appropriate for civil engineering infrastructure assets which can be re used to deploy fibre, and for which no reasonable case can be made for ‘efficient duplication’.

RAB approaches adopted by other UK regulators

3.12 A full RAB approach is well established in UK network regulation. Where a risk of over recovery exists, for example as a result of historic regulation, other industry regulators have taken the necessary actions to adjust the RAB at the start of a price control period to ensure that any such over recovery will not continue in future periods.

3.13 The following examples (from different industries) illustrate this approach:¹¹

- In 1997, the RAB for Northern Ireland Electricity was adjusted downwards by £97m for an underspend in capex unrelated to efficiency).¹²
- Also in 1997, the RAB of the gas pipeline operator, Transco. was written down by 40% to ensure that the discount on book value on privatisation was taken into account appropriately.¹³
- In 2002, the RAB of airport operator, BAA was written down by £135m, to avoid double recovery of pensions costs.¹⁴

3.14 We note that none of these examples, nor Ofcom’s own 2005 RAB adjustment amount to retrospective regulation; they do not remove any over recovery of costs in previous prices, but rather seek to avoid any further over recovery in future.

3.15 In summary, the EC guidance, Ofcom’s RAV adjustment in 2005, its objectives in the current WFTMR review and the approaches taken by other regulators all recognise that the RAB value of a non-replicable asset should not be set at current values. A current value approach is relevant to incentivise a “build or buy decision”, but as it will not be economically viable for a competing operator to replicate these assets at any price, it is not appropriate for use in relation to assets such as ducts.

3.16 For such assets. the RAB should rather be set as the costs incurred to date to bringing the asset into its current condition, where these costs have not already been recovered through revenue. Such an approach, which is usual in other network utilities, ensures that the owners of the assets achieve a fair, but not excessive, return on their investment over the life of the

¹⁰ [Ofcom Consultation Document “Valuing Copper access Part 2 – Proposals”](#) 16 March 2005 Paragraph 3.20

¹¹ For summary of these and other examples see [“UR-151 Correcting for Unforeseen Outcomes: Regulatory Precedent”](#) published on gov.uk

¹² See [Monopolies and Mergers Commission \(MMC\), Northern Ireland Electricity plc- Conclusions, 1997](#)

¹³ See [MMC, A report under the Gas Act 1986 on the restrictions of prices for gas transportation and storage services, 1997](#)

¹⁴ Competition Commission , BAA Plc: A Report on the Economic Regulation of the London Airports Companies, 2002

asset. It ensures that the asset investors are appropriately incentivised, but avoids these investors earning economic rents that would add unnecessary costs to the users of the assets.

3.2 Benefits of the full RAB approach

3.17 While, as we argue above, the full RAB approach is required by legal and economic considerations, its adoption will also deliver a number of practical benefits.

Full RAB approach will give long term price stability

3.18 Openreach and Ofcom have raised legitimate concerns about fluctuating prices over time as the apportionment percentages whether based on space utilised or addressable market will vary, in particular in the longer term once copper is removed.

3.19 However, in a full RAB approach any duct costs relating to copper will only be included if they have not been previously recovered. In practice, as we explain below, it is unlikely that any significant costs will now remain unrecovered from the duct installed to house copper cable.

3.20 In using a full RAB approach it would be appropriate to base the cost apportionment on the number of operators expected to share the duct in the long term as Openreach propose and hence guarantee long term price stability in the PIA product set. This would allow Openreach to recover appropriate costs from those CPs utilising the duct network but would prevent them from recovering costs already recovered in previous years (e.g. from active services sold by Openreach).

Full RAB approach will attract investment for Openreach's physical infrastructure

3.21 As noted above the use of a RAB does not diminish BT's ability to attract capital to invest in the physical infrastructure assets of Openreach, as future capital spend will earn the regulated return (and as we explain below, past spend will have earned more than this return, even after the RAB adjustment).

3.22 A RAB approach is well established in utilities as a means of attracting investment as it provides certainty to investors on the future return. It should therefore allow BT to attract investors seeking lower risk and hence lower its cost of capital in respect of PIA.

Full RAB approach will encourage competition and increase scope for commercial full fibre deployment

3.23 For other operators, utilising the full RAB approach will avoid significant price rises in PIA costs either now or in the longer term (post 2026) when Openreach copper withdrawal gets underway. From Openreach's RFS, we note that PIA charges represent c. 15%¹⁵ of the annual ongoing costs of a line and Openreach's costs are likely to be broadly representative of other operators.

3.24 Thus adopting this approach will reduce costs for CPs, enabling them to invest in areas that otherwise would not be commercially viable. This will increase the level of competition as well

¹⁵ BT's 2019/20 RFS section 7.1.2 show that for an MPF annual rental service £2.65 of total FAC £47.28 relates to PIA charges and for FTTC 40/10 annual rentals £17.05 of total cost £84.10 relates to PIA charges. PIA charges are thus 15% of the aggregate cost for an MPF+FTTC 40/10 service. FTTP services are not reported separately in BT's RFS so we are using MPF+FTTC as an approximation of the costs of an FTTP line for this purpose.

as increase the scope for commercial full fibre deployment, thereby reducing the need for public subsidy to support fibre network deployment.

A RAB approach will ensure a level playing field between Openreach and other operators

3.25 The RAB approach enables an entirely level playing field between Openreach and competitors. In its business cases Openreach would not include contributions to sunk costs but would make decisions on a forward-looking basis. Under Ofcom's proposals, other CPs however would pay a PIA charge that includes an element of contribution to prior period spend. Under a RAB model however Openreach and other CPs will face identical costs as they are each contributing their share of future incremental spend via the PIA charge.

Full RAB approach will allow switch to CPI in asset indexation

3.26 The use of RPI as an indexation amount is being phased out by all other regulators in the UK as it is no longer an official statistic and is generally considered to overstate the value of general inflation due to methodological flaws. Ofcom itself no longer uses RPI in formulae and opex projections, but has maintained its use for capital assets, presumably because of the difficulties in switching the values of existing assets, as has been experienced in other regulated industries.

3.27 The use of RPI in Ofcom's modelling is however distorting price estimates and overstating projected asset values, which is particularly important with the longer, five-year review period now being used. By adopting the RAB approach at this time, when spend to date has been largely recovered, Ofcom can adopt CPI without the methodological complexity that would otherwise arise. In other words, making the change now, while it would require a significant degree of work, would yield considerable long-term benefits for both Ofcom and industry.

Full RAB approach will allow capex efficiency to be incentivised

3.28 As we previously noted, Ofcom's existing approach provides little incentive for Openreach to be efficient in its capital spend. Indeed, it encourages capex inefficiency at the end of the review period and would also encourage operating expenditure to be classified as capital expenditure where possible, as the opening asset value currently used in Ofcom's models is not adjusted for inefficiency. A RAB approach would allow Ofcom to ensure that Openreach has incentives in capital as well as operating spend, by adjusting the opening RAB in the next charge control to exclude inefficient spend (reduce RAB) and reward efficiency (increase RAB).

3.3 Applying a full RAB approach to PIA cost model

Valuing the opening RAB

3.29 To fully value the opening RAB Ofcom would need to take the following steps:

- Take the RFS for each year since 2005 and calculate the return in excess of the regulated WACC as assessed by Ofcom at that time. As the RAV adjustment was made in 2005 and removes over-recovery in periods prior to this, we believe it can reasonably be assumed that the opening position for 2005/06 does not require any adjustment.

- Remove any excess return for non-access products (i.e. calls products), which use little or no physical infrastructure, so any over recovery could not be attributable to duct).
- Remove excess for products where excess return was legitimately allowed by Ofcom to incentivise static efficiency (i.e. where a cost-based price cap had been imposed)
- Where there are assets remaining on the regulatory book value for any year, the excess should be attributed between them using a reasonable basis such as remaining book value. Note that as duct has the longest asset life of BT's assets, then for the earlier years this will give a heavier weighting to duct for the excess returns than in more recent years. Note that attributing excess recovery to downstream assets will not require the price controls for these assets to be adjusted, as these prices are not calculated on a RAB basis.
- The remaining over recovery should be deducted from the RAB value for duct for each year (i.e. closing RAB for each year = opening RAB + book revaluation – book depreciation – over recovery as calculated above).

3.30 Although we have not performed this calculation in detail, we can make a reasonable approximation on the basis of publicly available information.

3.31 Firstly, Frontier Economics, in a report prepared for Vodafone calculated that the total excess return for the period from 2006/07 to 2016/17 was £10.5bn.¹⁶ To this we add the returns for 2017/18, 2018/19 and 2019/20 which total £1.3bn¹⁷ to give total excess returns of £11.8bn for the period since 2006/07.

3.32 This over recovery is over twice the current book value of the duct and poles, (£5.5bn from Ofcom's pricing model) and as the adjustments we set out above will be relatively small, it is very likely that a full calculation will show that the spend to date on the existing duct and pole network has already been recovered substantially, or even in full.

Recovery of ongoing PIA spend by Openreach

3.33 Having established the opening value of the RAB (which as set out above would likely not be significant) we would then need to consider how to treat subsequent capital expenditure. We consider that there are broadly three ways this could be done:

- Capitalising any future capex** – which would involve building up a new RAB from the incremental capex. The RAB would grow each year by the value of the new capex, by an allowance for inflation (which as above we suggest should be CPI, not RPI) and be reduced by the annual depreciation. Prices each year would cover ongoing opex, the depreciation (net of the holding gain) and a return on capital employed (ROCE). This approach would result in lower prices in the short term (e.g. the first 5 years) but higher prices beyond that as the annual net depreciation and ROCE increased.
- Pay share of capex as we go** – set prices each year to cover the aggregate of in year opex and capex. In this option the RAB would never build up, meaning that no return on capital or depreciation would need to be calculated. This approach would result in

¹⁶ [Frontier Economics "Profitability and the Incentive to Invest" 28 September 2017](#)

¹⁷ See Annex 1 for calculation

higher prices in the short term than the first option but lower prices in later years, particularly when the rollout is complete.

- iii. **Hybrid approach** – which would involve capitalising all capex required to expand and enhance the network, including network adjustments below the limit for charging individually to CPs, which can then be recovered against revenue over the asset's lifetime. For capex required to replace existing assets, this would be recovered against revenue in the year that it is incurred, which would allow a constant contribution to ongoing spend by those users of the network at that time. This approach would result in a pricing profile that would be between the first and second approach (although likely to be closer to the second).

3.34 Of the above options, we consider that the third approach is like to be most appropriate for PIA because it is the approach that best ensures price stability over time. However, any of these approaches are valid ways of creating a RAB.

Quantification of the impact of adopting a RAB (compared to Ofcom's current proposals)

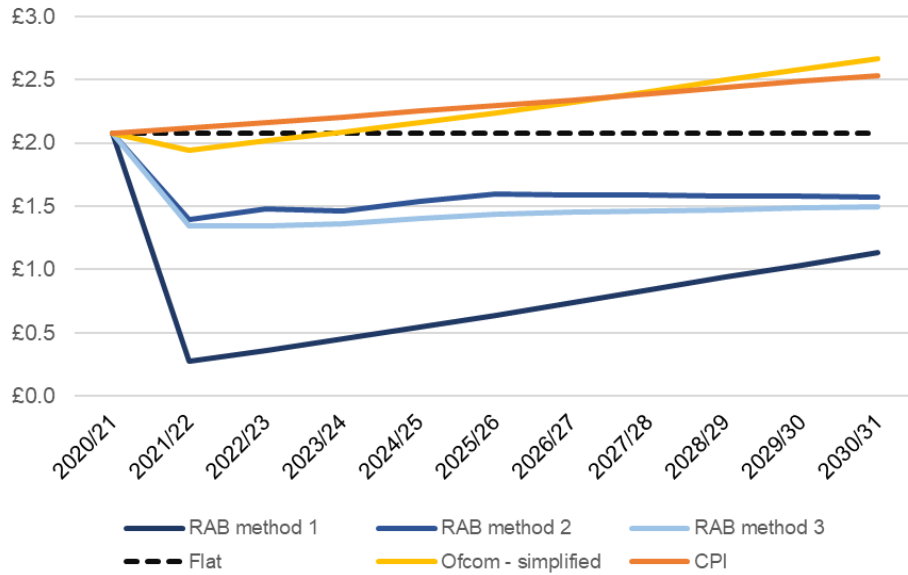
3.35 To give an indicative value of the impact of moving to a RAB, we have adjusted Ofcom's non-confidential model to produce a number of scenarios. We set out below a chart for each PIA service that we have modelled, for each chart we show six scenarios.

- **'RAB method 1'** – based on the first approach set out above, i.e. capitalising any future capex.
- **'RAB method 1'** - based on the second approach set out above, i.e. ii. Pay share of capex as we go.
- **'RAB method 1'** - based on the third approach set out above, i.e. hybrid approach.
- **'Ofcom - simplified'** – based on Ofcom's model, and utilisation rates as in the consultation, but with the simplifications we have used on our own modelling to allow comparability of the indicative values
- **'Flat'** – based on keeping prices flat (at 2020/21 levels) in nominal terms, i.e. CPI-CPI
- **'CPI'** - based on keeping prices flat (at 2020/21 levels) in real terms, i.e. CPI-0

3.36 All of these are based on the same starting price value, which is that on Openreach's current price list, i.e. as of December 2020.

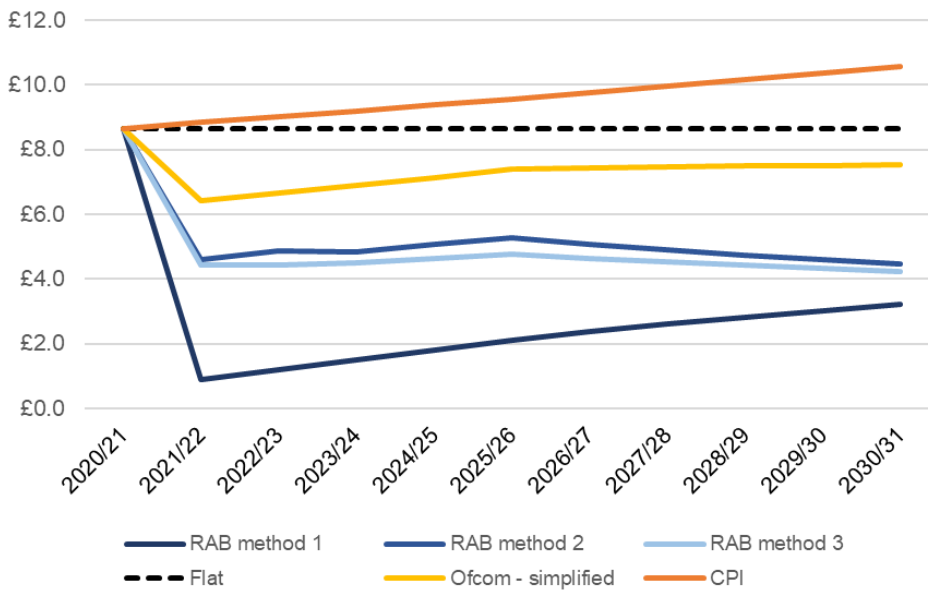
3.37 We show below six charts for each of the following PIA products: joint boxes; manholes; lead-in duct; single bore; 2 bore; and 3+ bores.

Figure 3.1 CityFibre scenario modelling for joint boxes



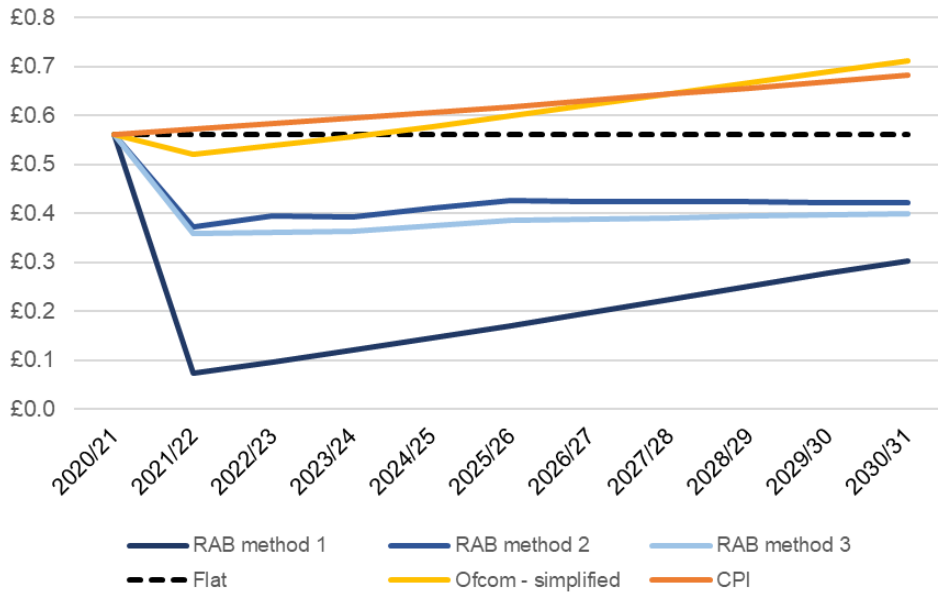
Source: CityFibre

Figure 3.2 CityFibre scenario modelling for manholes



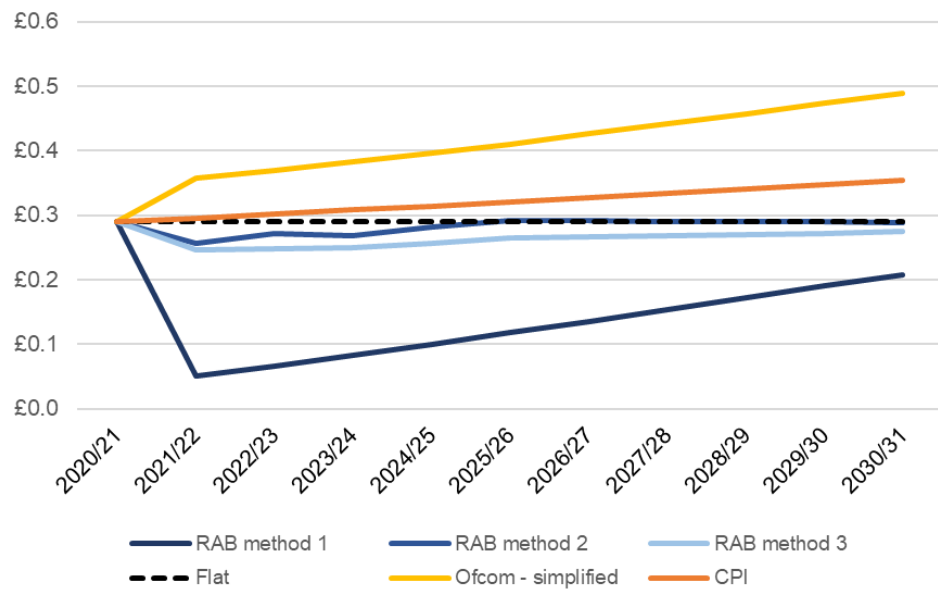
Source: CityFibre

Figure 3.3 CityFibre scenario modelling for lead-in duct



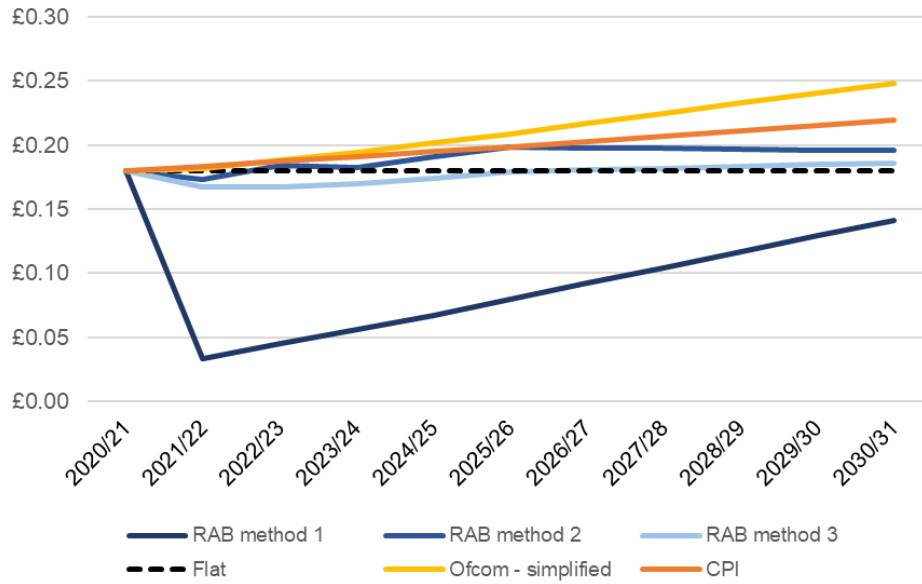
Source: CityFibre

Figure 3.4 CityFibre scenario modelling for spine duct: single bore



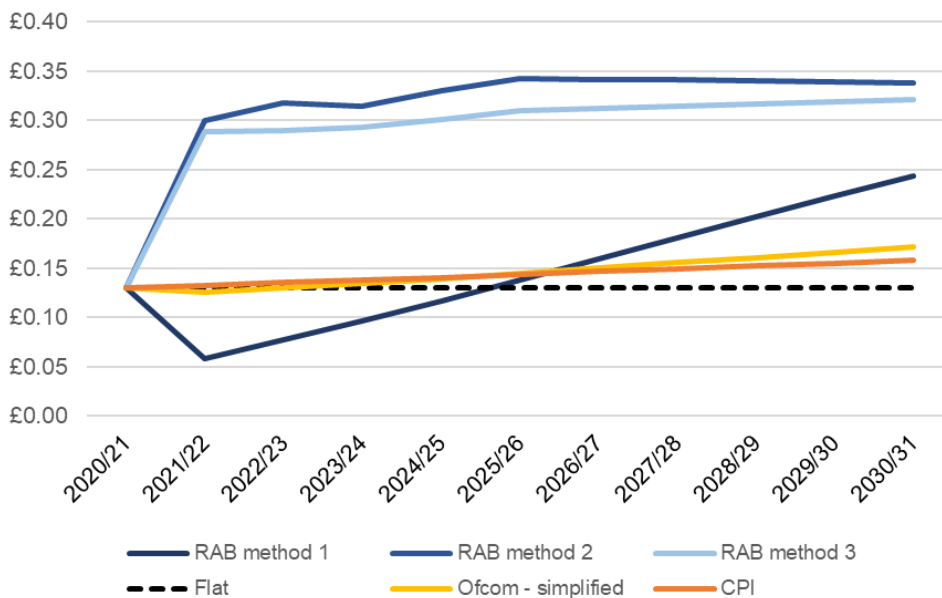
Source: CityFibre

Figure 3.5 CityFibre scenario modelling for spine duct: 2 bore



Source: CityFibre

Figure 3.6 CityFibre scenario modelling for spine duct: 3+ bore



Source: CityFibre

3.38 We wish to stress that these are indicative results, given that Ofcom utilises (in the published non-confidential model) randomised variables for all Openreach data (with a 20% tolerance). This includes critically both volume and cost data. As such, these outputs are indicative only and will need to be modelled with the actual input data from Openreach, that Ofcom has access to, before final conclusions can be drawn.

- 3.39 Notwithstanding this, what can be seen clearly from the above analysis is that moving to a full RAB approach will result in flat or falling prices for most PIA products.
- 3.40 Specifically, for joint boxes, manholes and lead-in duct, we can see that all three RAB methods result in prices being significantly below the 'flat' (i.e. CPI-CPI) line, across the entire period modelled (i.e. up to 2030/31).
- 3.41 For single and 2 bore duct we note that some RAB approaches result in prices below the 'flat' (CPI-CPI) line, with some approaches resulting in prices broadly equal to CPI-CPI. Given this we consider that CPI-CPI or possibly CPI-0 would be appropriate.
- 3.42 For the 3+ bore product, the analysis below shows that under a RAB approach prices should increase, e.g. rising by more than CPI.
- 3.43 On the basis of our modelling we consider that it would be most appropriate for Ofcom to ensure that, with the exception of 3+ bore spine, prices do not increase in the upcoming market review period.

The glide path for pricing has not been correctly calculated in Ofcom's model

- 3.44 In modelling the glide path in its model, we note that Ofcom has taken a different approach to all previous reviews.
- 3.45 It would be usual practice in using a glidepath approach to calculate the price for the final year of the next review, compare this with the price in the final year of the current review (2020/21 in this case) and set an X value such that CPI-X will achieve the price change evenly over the market review period, in this case five years..
- 3.46 Instead, Ofcom has applied the formula from the current review period (i.e. ending in 2020/21) to the 2018/19 prices to derive the first-year price of the next review period, 2021/22. It then has calculated the X to give a four-year glidepath to the final year.
- 3.47 We believe that this is an error in Ofcom's modelling and that Ofcom should correct it in calculating the price control.

Alternative interim approach that Ofcom could adopt

- 3.48 We understand that the approach we have set out in this paper would represent a significant departure from the PIA cost modelling approach that Ofcom has previously used. Although it would be in our interests to adopt a RAB based methodology now, we accept that it may be unrealistic to expect Ofcom to be able to undertake the necessary analysis in time for the current market review period. As set out above however, neither do we believe that immediate price increases of the type proposed by Ofcom are necessary.
- 3.49 Openreach has previously refused to consider the withdrawal of redundant copper to relieve congestion in the short to medium term so we do not think there is any pressing need to deal with the problems identified by Openreach since there is unlikely to be any change in the allocation percentages during the next market review period. We believe it would be more sensible to take no dramatic action for this market review but to take the necessary time to consider fully the arguments advanced by all interested parties rather than acting only on the concerns identified by BT and Openreach.
- 3.50 This would allow Ofcom time to conduct a consultation on moving to the full RAB approach at the time of the 2025 market review. In the interim Ofcom could perhaps consider an interim

solution, such as keeping prices flat in real terms for the current market review period, in line with the price caps that it is proposing for Openreach's main active service prices.

4 CityFibre's views on other matters in the consultation

- 4.1 We welcome Ofcom's proposals to clarify the basis of charges obligation on PIA ancillaries pricing as fully allocated costs. We consider that the "DSAC" standard as a price ceiling would have allowed Openreach the opportunity to increase prices to include an excessive share of fixed and common costs, without any reassurance that such a price change would have been accompanied by compensating price reductions on other PIA services. Side wide-reaching pricing flexibility would introduce significant risk of regulatory gaming.
- 4.2 In relation to Ofcom's proposals for Dark Fibre access we would refer to the comments on this in our response to the January 2020 WFTMR Consultation. If Ofcom is minded to mandate Openreach to provide dark fibre then the prices should be set to reflect the costs of a reasonably efficient operator.

Annex 1 – BT returns in excess of WACC in regulated markets

	2017/18	2018/19	2019/20	Total
	£m	£m	£m	£m
Mean Capital Employed (MCE)				
Copper SMP markets				
WLA	5,637	6,077	4,814	
WFAEL	4,638	4,518	2,383	
ISDN2	134	125	67	
	10,409	10,720	7,264	
PIA market			4,939	
Other SMP markets	3,080	2,882	1,790	
Total SMP markets	13,489	13,602	13,993	
Regulated WACC				
Copper SMP markets	8.8%	8.1%	8.1%	
PIA market			7.1%	
Other SMP markets	9.8%	9.8%	9.3%	
Regulated return (MCE x Regulated WACC)				
Copper SMP markets	916	868	588	2,373
PIA market			351	351
Other SMP markets	302	282	166	751
Total SMP markets	1,218	1,151	1,106	3,474
Less: Actual reported return	(2,141)	(1,355)	(1,277)	(4,773)
Return in excess of regulated WACC	(923)	(204)	(171)	(1,299)

Notes

All inputs to the table are extracted from the BT Regulatory Financial Statements for the relevant year. Copper SMP markets are those for which the lower “Openreach” WACC (weighted average cost of capital) is applied in regulatory pricing models.

For simplicity, in this table the Wholesale Local Access (WLA) market has been assumed to be entirely a copper SMP market, but certain services within the market are in practice modelled using the higher “Other UK Telecoms” WACC.

PIA was first reported as a separate market in 2019/20 but within a number of other regulated markets in earlier years.

Annex 2 – Indicative values for PIA prices using a RAB approach

[Attached to this response as an Excel file]