Assessment of Openreach profitability

Findings and considerations for TAR

Non-Confidential Version

Ofcom’s updated impact assessment guidance outlines its intention to evaluate its regulatory decisions, and the benefits that such evaluations will bring

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Where considered appropriate, we will monitor and evaluate the actual outcome of a policy in a proportionate way.
[…]
Depending on the nature of a regulatory intervention, we may also consider it appropriate to assess its wider impact, for example, across a market as a whole.

“

Evaluation improves our policy-making by allowing us to see when things have not worked out as we expected, and learn from these cases.

**Source: Ofcom, Impact assessment guidance, 19 July 2023, paragraphs 4.38-4.40 https://www.ofcom.org.uk/about-ofcom/corporate-policies/better-policy-making-ofcoms-approach-to-impact-assessment/*

The returns from Openreach (OR) services are a useful input to evaluate the impact of decisions made in WFTMR 2021

Price continuity / flexibility was allowed on certain OR wholesale services, with the expectation that this would incentivise additional investment by OR and/or competing networks

- WLA: CPI-0 control on MPF and FTTC/FTTP 40/10 in WLA Area 2 & 3; fair and reasonable obligation on higher bandwidths
- LLA & IEC: CPI-0 control on LL rental & connection charges in LLA Area 2 & 3 and BT Only & BT+1 exchanges; fair and reasonable obligation on LLs in LLA HNR areas

- OR profitability on these services in-line with what was expected to incentivise additional investment?
- Did this result in the expected level of additional investment?

Cost-based charge controls imposed on services where Ofcom expected limited scope for additional investment by competitors

- PIA
- LLA Dark fibre services in Area 3
- IEC Dark fibre services at BT Only Exchanges

- OR profitability on cost-based charge-controlled services in-line with the determined WACC?

Removal of regulation where OR was expected to face effective competition / in markets where the structure was expected to tend towards competition

- LLA services in the CLA
- WFAEL services (incl. WLR)

- OR profitability on services within Non-SMP markets consistent with workable competition?

We have assessed OR's returns in different markets based on its FY21-24 Regulatory Financial Statements, and identified potential considerations for TAR

Elements looked at in our assessment

- OR Return on Capital Employed (ROCE) in SMP markets - overall, and by product where possible
- ROCE across OR non-SMP markets – these will include a wider set of services than those deregulated in the WFTMR: excessive profitability on this segment could be an indication that further investigation is necessary
- The level of ROCE versus the determined WACC*, and trends over FY21-24. Only FY22-24 are part of the WFTMR 2021 period, but FY21 included as a reference starting point

We use OR's returns adjusted for the impacts of higher-than-expected inflation, as this pushes OR profitability upwards

- High inflation led to significant holding gains in the asset value for passive infrastructure and copper cables. This resulted in low reported capital charges (as holding gains create a negative capital charge), and in turn boosted profitability
- BT has calculated and published adjusted returns for certain groups of markets and products in its Regulatory Financial Commentary, by estimating the holding gains if inflation had been as expected in WFTMR 2021
- We have based our assessment on these, but also present unadjusted returns from the RFS where informative
- **The adjusted returns may underestimate OR's "true" returns** – they exclude all the benefit that OR gained from increases in asset value due to the higher-than-expected inflation

**We make comparisons to the WACC rates determined in WFTMR 2021, which applied from FY22 onwards. Different WACC rates applied in FY21, but we have included only the rates that applied from FY22 in the charts, given the years from FY22 are those relevant for the WFTMR 2021 period*

Summary of findings and key considerations for TAR

OR made significant above-WACC returns in a number of SMP markets over FY22-24

- **>17%** on Copper-FTTC WLA, **>11%** on LLA, **>60%** on IEC, **>15%** on Shared Ancillaries
- Translates to **c£1.9bn** in above-WACC returns (£1.25bn Copper-FTTC WLA; £260m LLA, £290m IEC, £80m Shared Ancillaries)

Assess if costs and benefits from price continuity / flexibility approach on WLA/LLA/IEC services has matched expectations

- Drivers of high returns, particularly on IEC?
- Expected level of altnet FTTP investment?
- Have FTTP altnets been "multi-service" WLA/LLA providers to the extent expected?
- Expected incremental rival IEC investment?

Assess drivers of excess returns on ancillary services

- Evidence of abusive behaviour (e.g. excessive pricing, reduced QoS)?

OR returns on IEC dark fibre services in BT Only exchanges appear to be high and increasing, despite the cost-based charge control

Consider if the cost models used to determine cost-based prices need to be adjusted

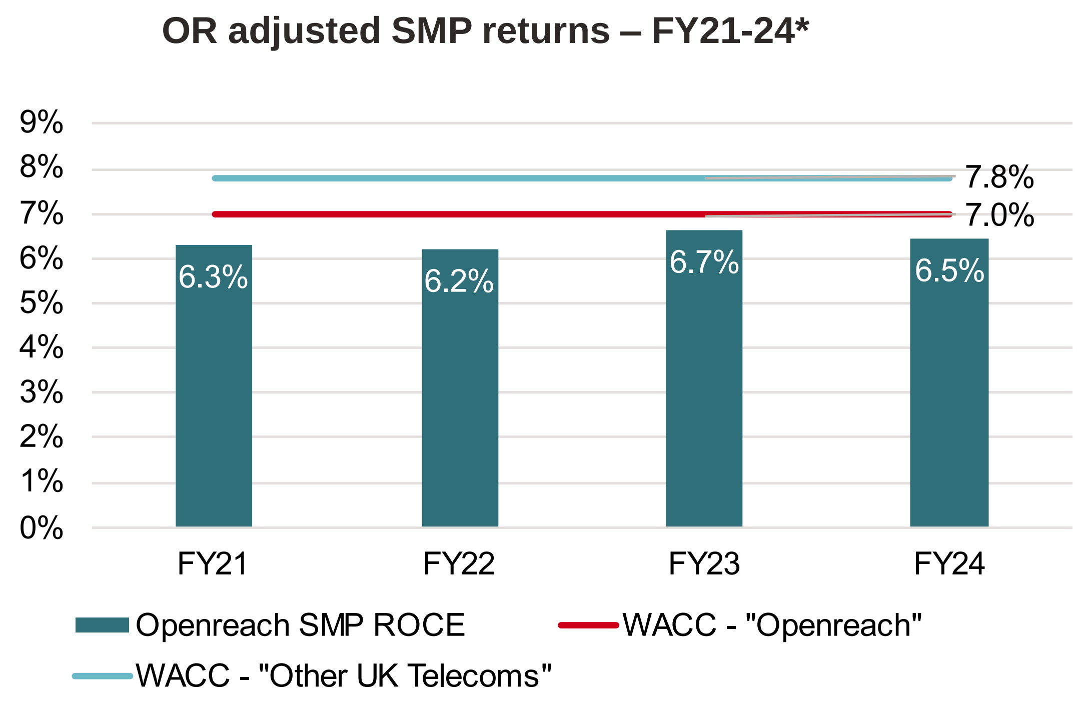
OR returns across non-SMP markets have been above the relevant WACC since FY21

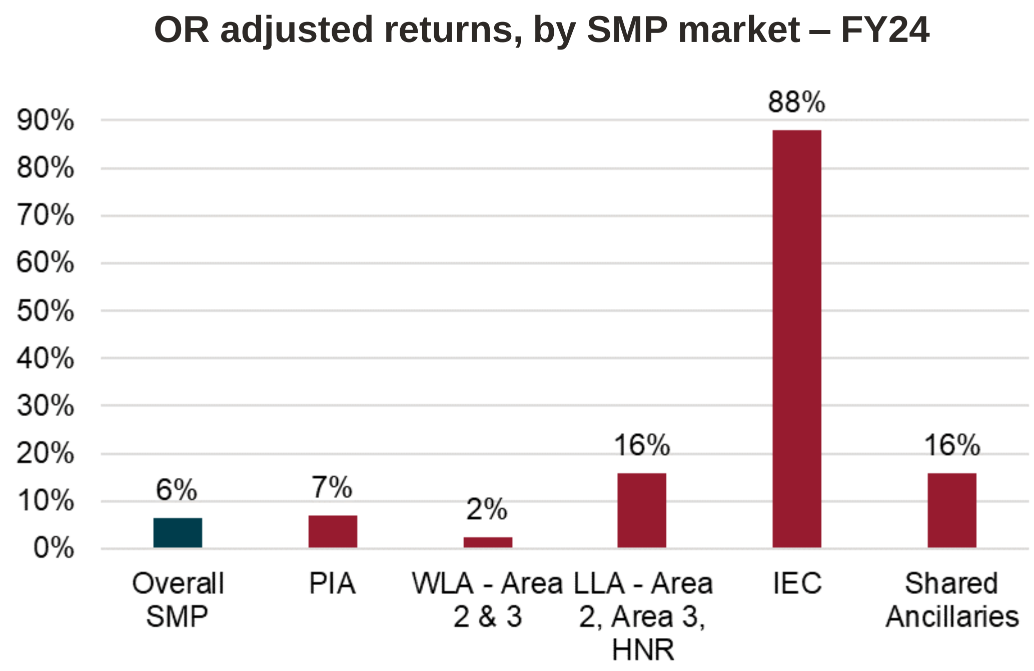
Further investigate non-SMP returns

- Competition not sufficient to constrain OR prices?
- Is attribution of costs between regulated / non-regulated services appropriate?

Assessment of Openreach profitability

OR's overall returns across SMP markets are below the determined WACC, but there is significant variation across markets





Share of OR SMP revenues (%) 13%** 64% 17% 4% 3%

*As per Annex 21 of the WFTMR 2021 Final Decision, the WACC for the "Openreach" category applies to PIA services, copper/FTTC WLA services, and dark fibre services in the LLA and IEC markets. The relevant WACC for the remaining Openreach services is that for the "Other UK Telecoms" category.
** PIA revenues included revenues from internal and external purchases, plus inputs to downstream services

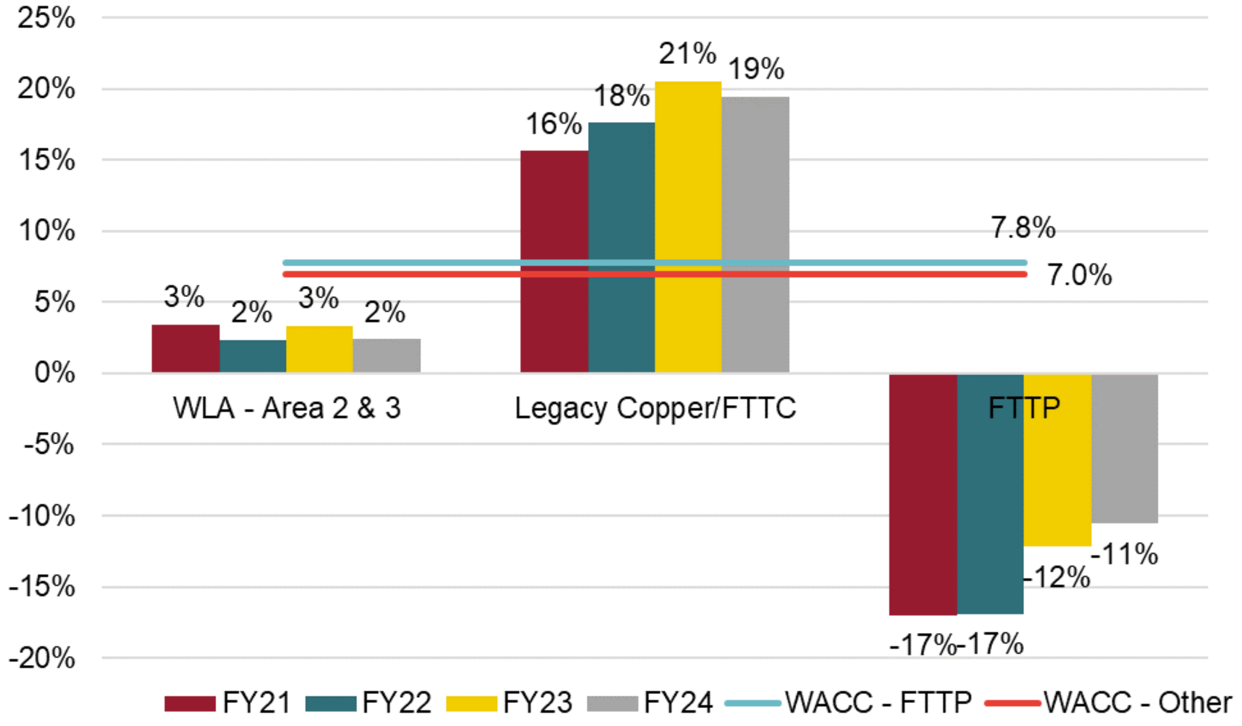
OR's overall WLA returns are depressed by low returns on FTTP services...

OR's ROCE on WLA services across FY22-24 was below the determined WACC…

… but returns are distorted downwards by OR's low returns on FTTP services during build out

- Depreciation and MCE for fibre build are calculated using the straight-line depreciation approach, so do not reflect the evolution of demand on FTTP networks over time
- As a result, reported returns are low for services on networks that are early in their lifecycle, even if performance is consistent with an appropriate level of returns (e.g. IRR =/> WACC) over the lifetime of the network

OR adjusted WLA returns across Area 2 and 3 – overall, legacy Copper/FTTC*, and FTTP



* BT define this group of services in its Regulatory Financial Commentary document, but do not specify which services are included. We assume that these cover MPF, FTTC, and SOGEA rental services

...with returns on copper/FTTC WLA services significantly above the determined WACC

ROCE on these services has been more than double the WACC across Area 2 and Area 3 since FY22

- ROCE has increased since FY22, despite reduction in rental volumes
- Translates to c**£1.25bn** in additional returns on these services over FY22-24, versus if ROCE reflected WACC*

ROCE above WACC was expected given Ofcom's chosen pricing approach…

- Ofcom rationale that higher prices would incentivise additional OR and rival FTTP investment

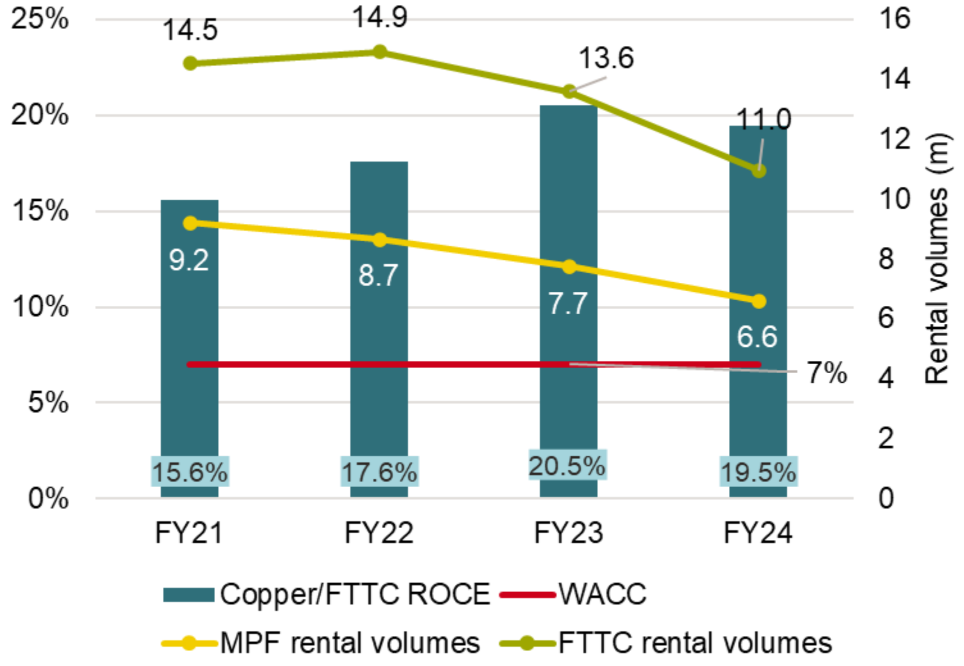
… but Ofcom should consider if outcomes on OR returns and the impact on investment matched that expected in WFTMR 2021

- Any returns above expectation will have imposed costs on consumers
- An ex-post assessment of the impact of higher returns on FTTP investment levels can help inform future policy

Consideration for TAR:

- Assess whether the costs and benefits of the pricing continuity / flexibility approach have been as expected in WFTMR 2021

"Legacy Copper/FTTC" WLA services in Area 2 & 3 – OR adjusted returns & rental volumes



 * See Annex for the calculation of this for these and other OR SMP services

OR returns on LLA services have also been significantly above WACC…

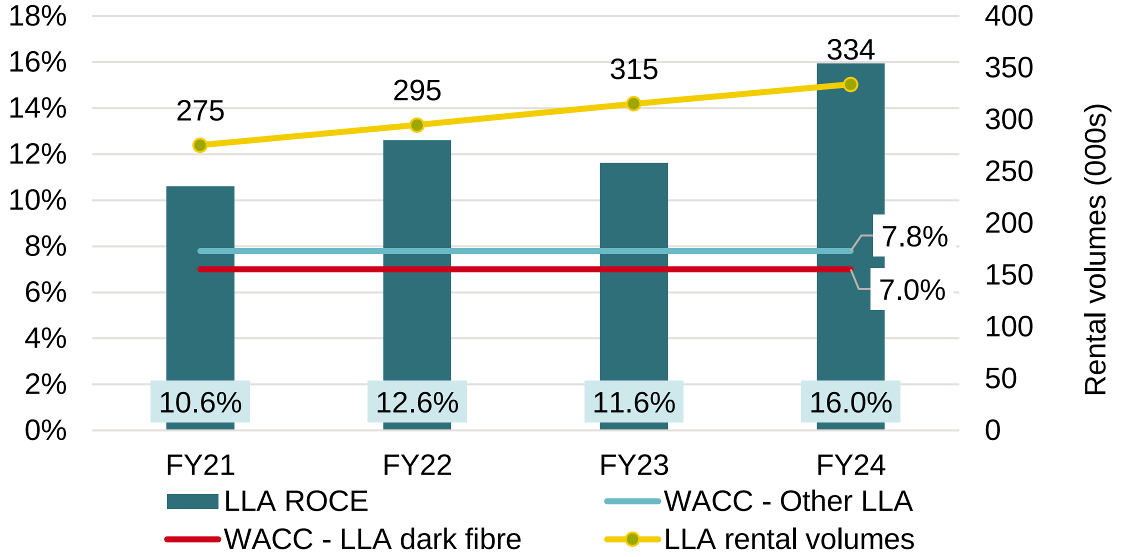
OR LLA returns have been above 11% in all years since FY22

- Translates to **c£260m** in additional returns on these services over FY22-24, versus if returns reflected the relevant WACC

These returns may also be understated

- BT allocates the cost of fibre cables between WLA and LLA services (amongst others)
- In recent years the total cost of fibre cabling has increased rapidly due to OR's extensive FTTP network roll-out for WLA
- However MCE for fibre assets allocated to LLA have increased significantly more than LLA line volumes, which appears inconsistent with the services that are driving these costs. As a result, OR's LLA costs could be overstated and ROCE understated

LLA services across Area 2, Area 3, HNR – OR adjusted returns and rental volumes



LLA Ethernet rental (Area 2 &3*): Fibre asset MCE vs rental volumes

LLA Ethernet rental	FY21	FY24	% change
MCE for 'Fibre' assets (£m)	776	1,278	**65%**
Rental volumes (000s)	239	277	**16%**

** Reflects Area 2 and Area 3 only, as BT's RFS does not include an MCE statement for LLA services in HNR areas*

… which again could be a concern if this hasn't resulted in material incremental rival investment

The allowed flexibility on OR LLA pricing was designed to incentivise additional investment by FTTP altnets…

- This was on the assumption in WFTMR that altnets deploying FTTP infrastructure would be "multi-service" providers i.e. would provide LLA as well as WLA services over this infrastructure

… but flexibility also imposes a cost on consumers

- If altnets cannot make sufficiently material returns from LLA services to consider providing these services, then the benefits of higher LLA prices may be immaterial

Consideration for TAR:

- Assess the costs and benefits of pricing flexibility vs that expected in WFTMR21, including if the mechanism through which excess LLA returns were expected to incentivise further altnet provision of LLA has been effective
- Assess if the allocation of fibre costs between services needs to be adjusted

OR's IEC products report very high returns, including the cost-based charge control on IEC dark fibre products

OR IEC returns across BT Only and BT+1 exchanges have been >60% and increasing since FY22, translating to **c£290m** in excess returns over FY22-24…

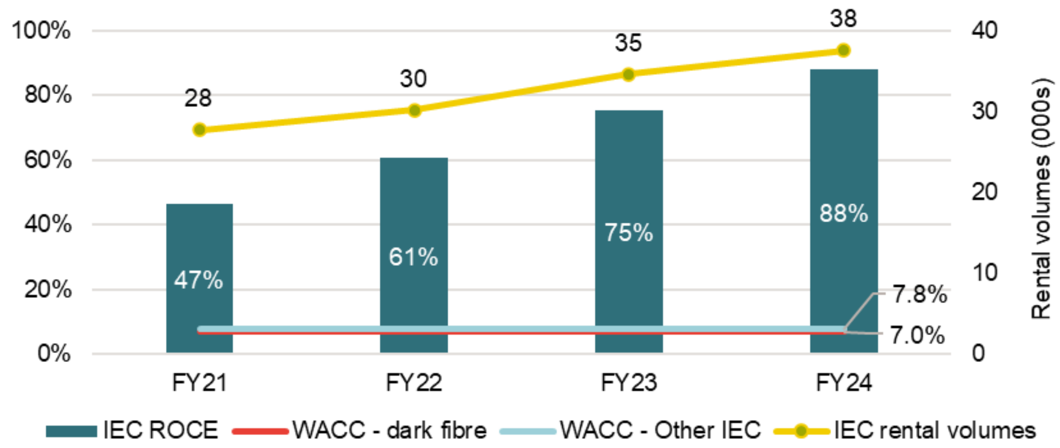
- Pricing flexibility was again allowed on Ethernet and optical services with the expectation that this would incentivise incremental rival investment
- It's unclear if there has been material additional entry – BT's exchange closure plan may mean rivals have less incentive to enter, given the likelihood of stranded assets

…(unadjusted) returns on IEC dark fibre services in BT Only exchanges are also high and increasing, despite these being subject to a cost-based charge control*

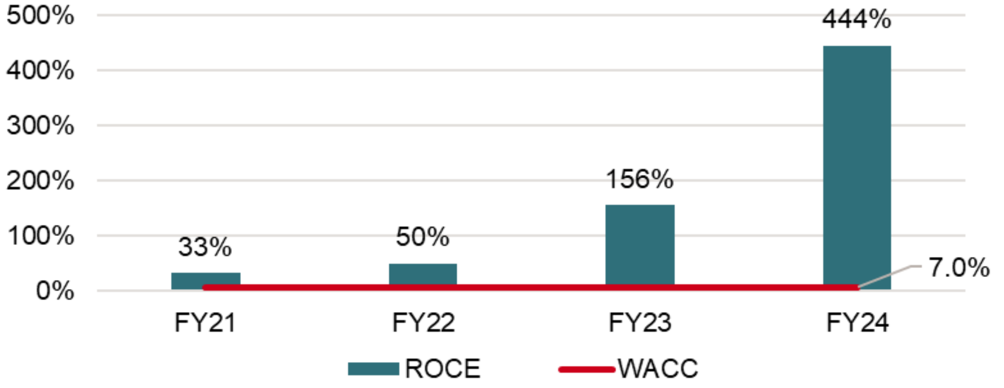
Consideration for TAR:

- Investigate drivers of excess returns on IEC services, incl. on Dark Fibre
- Assess if the high returns have or will be effective in stimulating incremental investment by rivals
- Consider if the cost models used to determine cost-based prices need to be adjusted

OR adjusted IEC returns (BT Only & BT+1 exchanges)



IEC dark fibre returns in BT Only exchanges (not adjusted for inflation)**



**BT does not present inflation-adjusted returns for these services, but it's likely returns will still be materially above WACC even with such an adjustment, as BT's inflation adjustments across all IEC products are relatively small (ORs unadjusted FY24 ROCE across IEC markets was 90%, vs 88% with the adjustment)*
*** The returns are calculated based on summing the revenues, opex, and MCE across different dark fibre services in the BT RFS, so could be impacted by rounding. Ofcom should investigate these returns based on underlying unrounded data from BT.*

Returns on ancillary services could be evidence that regulation has not prevented an abuse of market power

OR returns on Shared Ancillaries are also significantly above WACC, translating to c£80m in excess returns over FY22-24

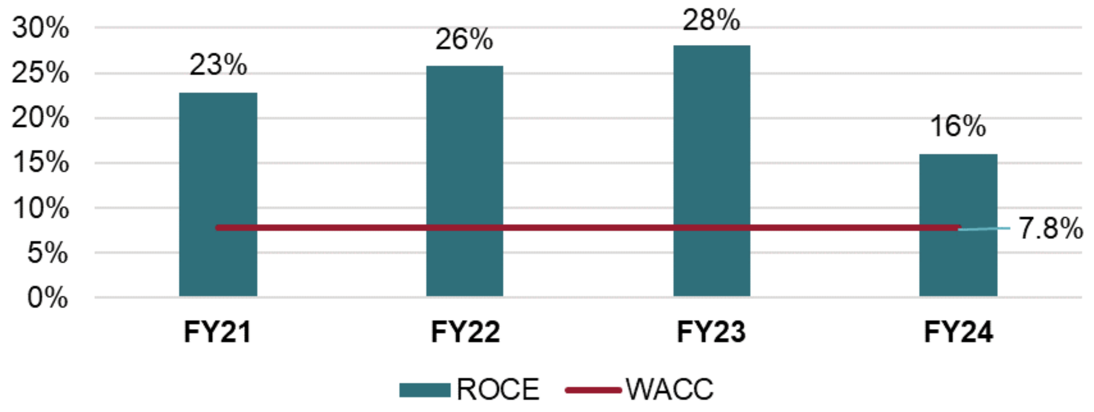
- OR's unadjusted returns indicate that this is driven by high returns on Accommodation services (which account for the majority of OR's Shared Ancillaries MCE/Revenues)

This could be evidence of abusive behaviour. For example, this could indicate that OR prices are excessive, or have increased returns through reducing quality of service and / or redefining the scope of services

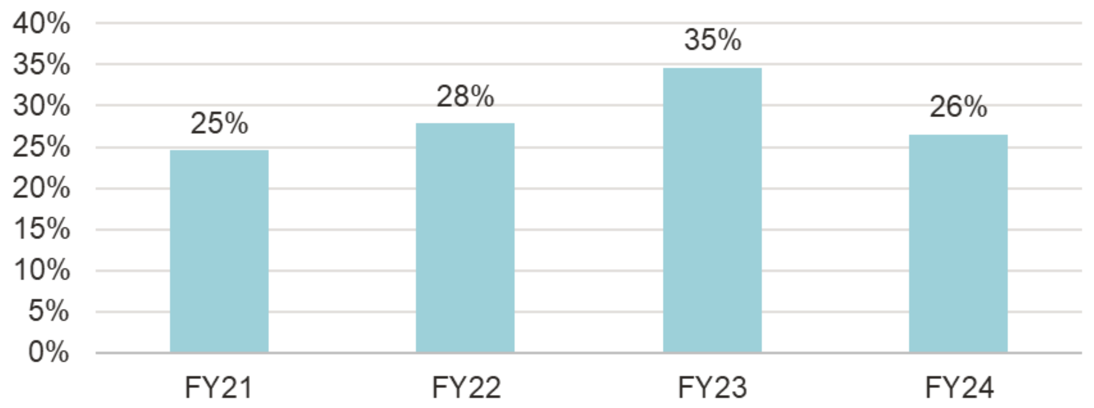
Consideration for TAR:

- Further investigate drivers of excess returns on ancillary services

OR adjusted return on Shared Ancillaries services – FY21-24



OR unadjusted returns for Accommodation services – FY21-24*



** BT's made only small inflation adjustments on Shared Ancillaries, so unadjusted returns by service are unlikely to differ significantly from the adjusted returns.*

*** Unadjusted returns in BT's RFS also suggest that OR made very large returns on selected WLA and LLA ancillaries in certain years (e.g. OR ROCE on "WLA Special Faults Investigation" in Area 2 was 200% in FY24, and 50% on "Time Related Charges" in LLA Area 2 in FY23). Ofcom should also investigate drivers of returns on these ancillaries more closely as part of the TAR.*

Ofcom should also review the reasons for above-WACC returns in Openreach non-SMP markets

Evidence suggests that OR returns across all non-SMP markets have been above 8% over FY22-24

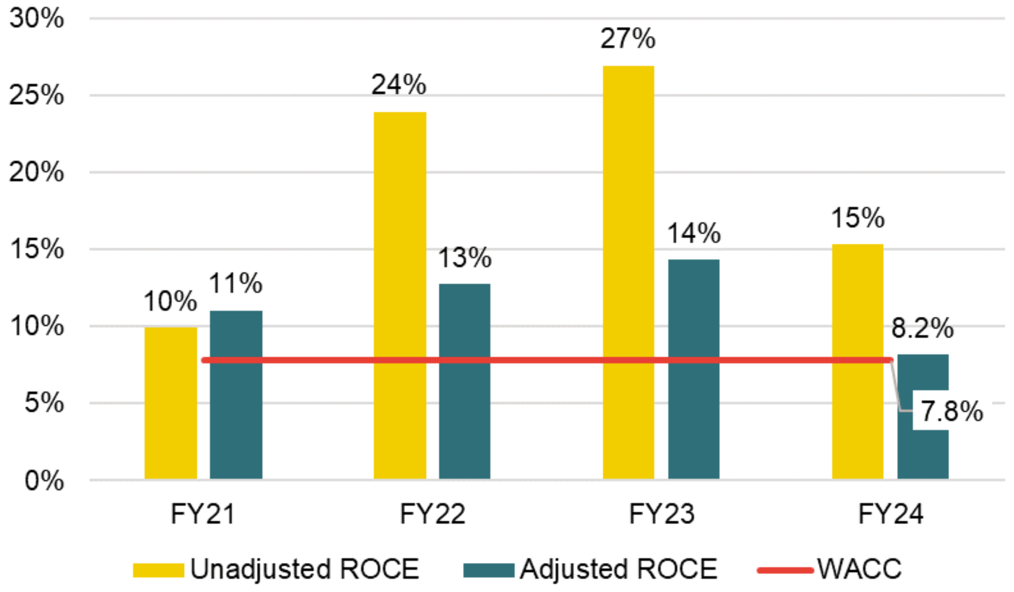
Ofcom should assess the effectiveness of competition in these markets.

- This includes markets where regulation was removed in previous market reviews, such as WLR, and LLA services in the CLA
- Competition may not have been sufficient to constrain OR prices at a competitive level
- Ofcom should also assess whether the attribution of costs between regulated and non-regulated services is appropriate, given the incentive to shift costs to regulated services

Considerations for TAR:

- Further investigate returns in non-SMP markets

OR unadjusted and adjusted Non-SMP returns – FY21-24*



** BT did not present inflation-adjusted ROCE for Non-SMP services for FY23 and FY24. However, if the inflation adjustment in FY23 and FY24 had the same relative impact on ROCE as in FY22, the adjusted ROCE in these years would have been above the relevant WACC.*

Annex: Analysis of excess returns

Excess returns over FY22-24: selected SMP markets / services

A monetary measure of OR excess returns on a given service can be calculated by taking the difference between its actual returns, and the returns it would've made had its ROCE been reflective of the determined WACC

- The latter can be calculated by taking the MCE for the service, and multiplying this by the relevant WACC

These excess returns total c1.9bn over FY22-24, across the OR SMP markets / services where OR made returns above WACC

- c£1.5bn is accounted for by ORs copper/FTTC WLA and LLA services, with c£370m accounted for by IEC and Shared Ancillary services
- While ORs % returns were lower on copper/FTTC WLA and LLA services vs IEC/shared ancillaries, these translate to larger excess returns in monetary terms, given these services represent a large part of ORs SMP business

		Calculation	WLA - Copper / FTTC	LLA - Area 2, Area 3, HNR	IEC - BT Only and BT+1 exchanges	Shared Ancillaries	Total
1	**Inflation-adjusted actual returns (sum over FY22-24)**		**£1,981m**	**£617m**	**£325m**	**£117m**	**£3,040m**
	ROCE - FY22-24 average		19%	13%	74%	23%	
2	MCE (sum over FY22-24)		£10,334m	£4,582m	£427m	£504m	£15,847m
3	Relevant WACC		7.0%	7.8%	7.8%	7.8%	
4	**Returns (if ROCE in-line with WACC)**	*2 x 3*	**£723m**	**£357m**	**£33m**	**£39m**	**£1,153m**
	Excess returns	*1 - 4*	**£1,258m**	**£260m**	**£292m**	**£78m**	**£1,887m**

** We use WACC of 7.8% for all LLA and IEC services, despite the relevant WACC for dark fibre services in these markets being 7.0%. We expect this to result in a marginal underestimation of excess returns, given we expect that dark fibre services represent a small share of LLA/IEC MCE.*

Actual returns, returns if ROCE=WACC, excess returns: selected SMP markets/services by year