

Response to Ofcom's consultation on non-domestic rates and the price for regulated Dark Fibre

Joint submission by Colt, Sky, TalkTalk, Three UK and Vodafone (the 'Passive Access Group')

**colt**



**TalkTalk**  
Group

**sky**



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## Introduction

1. The Passive Access Group (“PAG”) is a group of the UK’s major alternative communications providers – Vodafone, Sky, TalkTalk, Colt and Three. As fierce competitors, each has its own, individual ambitions and plans to secure the benefits that passive access will bring to our customers – and help us win new ones. But we have come together to speak with one voice to emphasise the clear and unequivocal case that we see for expanding the role of passive access to promote competition in UK telecoms markets. While this submission sets out issues all PAG members agree on, where there is a difference between the PAG response and a response by an individual PAG member, the individual submission takes precedence.
2. If Ofcom is to enable competition at 1Gbit/s and higher using DFA (as is its stated intention), it is essential that Ofcom designs the remedy in a way which takes into account the difference between BT’s non-domestic rates (“NDRs”) and the much higher NDRs which would be faced by many competitors of BT. This was recognised by the CMA, which determined that Ofcom’s initial approach – with CPs having to bear the burden of their NDRs being higher than BT’s – was not consistent with Ofcom’s objectives.
3. We are pleased that Ofcom has stated its intention in its consultation document that:  
*The principal effect of the proposal will be to simulate the choices that CPs would have faced under Ofcom’s preferred outcome, where the Government changes the rules on who pays the NDR costs.<sup>1</sup>*
4. The PAG agrees that if done properly, this exercise should result in a similar practical outcome as if the government had implemented Ofcom’s preferred approach of changing the rating rules so that BT would pay the rates for the dark fibre circuits which it provides to other CPs under Ofcom’s regulations.<sup>2</sup>
5. The PAG therefore welcomes much of Ofcom’s proposal. We acknowledge that Ofcom has largely reflected the CMA’s determination, and we believe Ofcom’s proposal will better simulate the choices that CPs would face if Government had changed the rules on who pays NDRs.
6. Furthermore, at this stage in the process, the priority for members of the PAG is to have price certainty so that they can begin planning their use of DFA. With this in mind, the PAG understands that Ofcom has put forward a proposal which relies on some simplifications, but does deliver price certainty. The PAG also acknowledges that the proposal will be in place for only half of the price control period, and that Ofcom will have the opportunity to obtain robust data during that period. In this context, the PAG agrees that overall Ofcom’s approach is sensible and proportionate. The PAG trusts that taking a looser approach now will enable Ofcom to adopt more robust assumptions for future price controls.

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<sup>1</sup> Ofcom, *Wholesale Local Access Market Review: Consultation on Duct and Pole Access Remedies* (20 April 2017) (‘consultation document’ or ‘condoc’).

<sup>2</sup> Ofcom Final Statement para A23.111.

7. With that in mind, this submission proposes an immediate change to only one of Ofcom's assumptions: the appropriate 'rate in the pound'. The PAG:
  - a) does not consider that the rate chosen can be reasonably justified – given the time period over which CPs will be liable for NDRs on DFA circuits; and
  - b) considers that there is a simple solution which can be implemented quickly and without requiring further consultation or delays.
8. The remainder of this submission focuses on further points where the PAG believes Ofcom's assumptions should be made more robust in future. On these points, the PAG would urge Ofcom to use the initial period in which DFA will be available to gather data so that at the next price control, Ofcom is equipped to provide a more sophisticated assessment of CPs' NDR costs. Specifically, the PAG urges Ofcom to revisit in future:
  - a) Its decision to calculate OCPs' NDRs by assuming a contiguous network of 1,000km or more – Ofcom has not yet provided a sound evidence base for this assumption. The PAG considers that actual evidence of major CPs who are likely to acquire DFA may lead to a different conclusion.<sup>3</sup>
  - b) Its methodology used to determine an average route length. The PAG would like to see a more transparent approach, with assurance that the route length and all other aspects of its calculations (such as the weight given to each of the mean and median lengths) is consistent with the CMA's reasoning, and more evidence-based assumptions about the way that main link route lengths differ to their radial distance.
9. Finally, the submission observes that it is unnecessary to make an upwards adjustment to the leased line charge control ("LLCC") since there is no real risk of BT under-recovering (indeed, Ofcom has granted Ofcom the ability to significantly over-recover, as it has in business connectivity markets for many years). Nor is there any need for a further cost-benefit analysis, given that Ofcom's proposal is directed at achieving the same outcome Ofcom originally intended.

## **Ofcom should immediately adjust the proposed 'rate in the pound'**

10. Ofcom has adopted as the 'rate in the pound' 47.9p, being the figure for England in 2017/18.
11. The PAG considers this decision questionable for two reasons:
  - a) First, the figure for England is substantially lower than in other parts of the UK (e.g. the rate in the pound reaches 58.7p for Northern Ireland). While many DFA circuits are likely to be in England, this does not mean Ofcom should entirely ignore rates payable in other parts of the country. In any event, Ofcom does not explain in the consultation document how it has reached this conclusion, its estimate of the proportion of DFA circuits which will be in

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<sup>3</sup> See, eg, TalkTalk's evidence referred to in para 13 below.

England (vs the rest of the UK) or the impact that ignoring the rest of the UK will have on its objectives.

- b) Secondly, Ofcom has apparently not turned its mind to the future rates which will apply over the course of the price control period, which will be substantially higher than the 47.9p figure which applies in 2017/18.
12. The PAG acknowledges that some further work will be required to determine the geographic spread of DFA circuits, and that Ofcom will have the opportunity to gather data on this following the launch of DFA. However, Ofcom should immediately adjust the 'rate in the pound' in order to ensure that Ofcom is not using old data (for the 2017/18 year) in years where a higher rate applies. Ofcom has visibility of the future rates, and its proposal can be easily and quickly adjusted to take these rates into account without further delay.

## **Future changes to Ofcom's approach to network contiguity will be beneficial**

13. In future price controls, the PAG would encourage Ofcom to revisit its assumption that CPs will use DFA as part of a contiguous network of 1,000km or more. The PAG has strong doubts about this assumption. It is important Ofcom gathers appropriate evidence once DFA is launched, so that this assumption can be revisited as necessary.
14. Ofcom explains this assumption on the basis that it:
- a) considers that a CP with a fibre network of 1,000km or more "represents an efficient (scale) operator".<sup>4</sup> Ofcom states that "several potential users of the dark fibre service already have networks of over 1,000km or are currently purchasing large volumes of active products from BT that could at some point in the future be converted to dark fibre";<sup>5</sup> and
  - b) consequently, explains that a lower measure of contiguity (i.e. assuming higher NDRs) would "over-compensate the larger operators and risk promoting inefficiency and/or arbitrage".<sup>6</sup>
15. We deal with each of these points in turn.

### **Whether a network of 1,000km represents an efficient operator at scale**

#### ***Ofcom has overstated the OCPs' network contiguity***

16. TalkTalk's evidence in the CMA was that at the end of the current LLCC period concluding in 2018/19, TalkTalk only expects a few of its circuits to be contiguous.<sup>7</sup> If TalkTalk – as one of the largest potential DFA users in the UK – has very few of its circuits contiguous, then very few other users of DFA are similarly likely to have large

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<sup>4</sup> Condoc para 2.16.

<sup>5</sup> Condoc para 2.16.

<sup>6</sup> Condoc para 2.16.

<sup>7</sup> Final Determination para 4.56.

contiguous networks. In this respect, it is surprising that Ofcom has stated only that “several potential users of the dark fibre service”:

- a) already have a contiguous network of 1,000km; or
  - b) are currently purchasing large volumes of active products that could “at some point in the future” be converted to dark fibre.
17. In relation to potential users who already have such a network, Ofcom does not specify how many such users there are; how many of those use the DRC method (since users who use the R&E method should be excluded from the analysis); or the proportion of total expected DFA uptake which will form part of a contiguous network of at least 1,000km. This type of analysis will be important to include in future price control decisions.
18. In relation to the possibility that active products could “at some point” be converted to dark fibre, we note that:
- a) First, Ofcom appears to be looking at migration at “any point in the future”. This does not appear to be the correct question. Ofcom should be concerned about whether, given migration forecasts over the next price control period, it is appropriate to assume OCPs will use DFA as part of a network with contiguity of 1,000km or more.
  - b) Secondly, it is hard to reconcile this view with Ofcom’s modest assumptions about migration of existing Ethernet services to dark fibre in its Final Statement.<sup>8</sup> Indeed, Ofcom has forecast that active services will decline only slightly in 2018/19. It is not clear how such a small migration to passive services would lead to a meaningful number of OCPs having contiguous networks of 1,000km or more.<sup>9</sup>
19. At the next price control, Ofcom should revisit these assumptions based on the actual experience of how CPs are using DFA.
- Ofcom has failed to address the fact that not all of a CP’s circuits are contiguous with all of its other circuits***
20. We also note that, even if a CP has a contiguous network of 1,000km, there is no guarantee that any particular DFA circuit will be contiguous with the rest of the CP’s network. In future price controls, Ofcom will need to consider whether, in each and every case, an existing circuit being migrated from Ethernet to dark fibre will contribute to the OCP’s total network contiguity.
21. This will not always be the case. Not every circuit is contiguous with the rest of an OCPs’ network: as is evidenced by the fact that, even today, CPs pay NDRs on circuits which are not contiguous with the rest of their network. This may occur, for example,

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<sup>8</sup> For example, in 2018/19 Ofcom forecast no migration at all of 10/100Mbit/s services (which constitute the vast majority of the market), less than 6% of overall 1Gbit/s services, and less than 24% of 10Gbit/s services (which themselves constitute only a very small proportion of the market). Final Statement, annex 32, table A32.1.

<sup>9</sup> Final Statement, annex 32, figure A32.16.

where a CP deploys dark fibre to connect two different customer sites, but where the link does not otherwise run contiguously with the rest of that CP's network.

22. We would encourage Ofcom to consider the extent to which new dark fibre circuits would be contiguous in future price controls, given that in the CMA proceedings, TalkTalk led evidence that "dark fibre rented from BT by TalkTalk will be, in many cases, non-contiguous".<sup>10</sup>
23. This issue is of particular concern given the Supreme Court's judgment in the Mazars case (*Woolway v Mazars* [2015] UKSC 53). As Ofcom will be aware, the Supreme Court in that case took a very narrow interpretation of the concept of "contiguity", making it much more difficult for ratepayers to argue that rateable properties may still be contiguous despite minor gaps between them. As rating authorities seek to apply the judgment in Mazars, including in a telecoms context, there is a real risk that an increasing number of circuits will be treated as non-contiguous.
24. Accordingly, this is an issue which we hope Ofcom will consider more closely in future decisions about the price of DFA.

**Whether an assumption of contiguity of 1,000km is necessary to avoid arbitrage and overcompensation**

25. The second reason cited by Ofcom is that a lower measure of contiguity (i.e. assuming higher NDRs) would "over-compensate the larger operators and risk promoting inefficiency and/or arbitrage".<sup>11</sup>
26. The CMA's final determination concluded that there was "*no evidence made available in this appeal of a material risk of productive inefficiencies from a move to DFA*" and that:

*"It also does not appear that there is a risk that a lower DFA price would result in higher profitability for OCPs in circumstances where they face lower NDRs, for example on short circuits".<sup>12</sup>*

27. The PAG does not consider that this is a robust justification for Ofcom's proposed approach, and would encourage Ofcom not to rely on this justification in its final decision. As Ofcom will be aware, fundamental decisions about its pricing of dark fibre (such as adopting an "active minus" approach, and the choice of a 1Gbit/s reference product) were driven by its fears of so-called arbitrage. Yet, in the context of the treatment of NDRs, the CMA promptly dismissed those concerns: "*all of the evidence presented, not least by Ofcom, indicates that this scenario is unlikely*".<sup>13</sup>

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<sup>10</sup> Second expert witness statement of Alexander Charles Stevens, para 4.4; see also First witness statement of Andrew John Heaney, para 23 ("in the last year of the charge control (2018/19) it is unlikely that many circuits will be contiguous with other circuits"). This position was taken in light of the VOA's Rating Manual which states that: "*contiguity does not include network routes or buildings connected by leased capacity on another operator's network*": Rating Manual, section 871, para 6.1. Therefore, if at any point an OCP relies on leased capacity between the dark fibre circuit and the OCP's core network (or if the core network itself contains leased capacity), the dark fibre circuit will be assessed as non-contiguous and attract a higher NDR rate than assumed by Ofcom.

<sup>11</sup> Condoc para 2.16.

<sup>12</sup> CMA Final Determination paras 4.191 and 4.192.

<sup>13</sup> CMA Final Determination para 4.191.

28. The CMA correctly identified that increased competition by different CPs using dark fibre (including where they have a rates advantage) is likely to put downward pressure on prices and margins, reducing the risk and extent of any overcompensation. This is, in effect, the argument which the PAG has long taken: that what Ofcom terms “arbitrage” is actually a form of competitive entry which – even if it simply “closes a gap” by requiring BT to change its pricing structures to those that could apply in a fully competitive market – has positive impacts on competition. In any event, an increased ability to compete (based on favourable rates or otherwise) creates greater consumer benefits and should be an outcome which we would expect Ofcom to welcome.

**Conclusion: a more detailed and evidence-based assessment NDR costs will be helpful for future price controls**

29. For the reasons above, the PAG believes the initial period in which DFA is available will allow Ofcom to gather data, so that it can ensure its assumptions and methodology is robust for future price controls. Accordingly, at this point the PAG urges Ofcom to:
- a) move away from inappropriate justifications and reasoning in its final decision (i.e. any suggestion that its decision is driven by eliminating any possibility for overcompensation); and
  - b) commit to obtaining appropriate evidence so that a more robust decision can be made for the next price control period.

## **Future changes to Ofcom’s assessment of route length distance should be considered**

30. In future, the PAG would also like to see a more robust approach to route length distance calculations. In this consultation document, Ofcom proposes to make a fixed adjustment to the price of DFA and DFA LA based on the average length of existing 1Gbit/s EAD and EAD LA services (determined by straight-line multiplied by 1.4 to estimate the route length). Ofcom determined this adjustment based on a Openreach’s inventories, showing that:
- a) For EAD LA outside the CLA, the median route length is 1.9km, and over 90% of circuits have a route length of less than 4km; and
  - b) For the access segments of EAD outside the CLA, the median length is ‘similar to’ the median for EAD LA services, and therefore for simplicity Ofcom adopts a median route length of 1.9km.
31. For main links between exchanges, Ofcom proposes to make an adjustment will be made on a per-metre basis, and assumes the radial distance is a good approximation for the route length.

**It would be helpful for Ofcom to demonstrate that these figures are consistent with the CMA’s final determination**

32. Separating out main links means that stakeholders are unable to verify that Ofcom’s estimated average lengths are consistent with those adopted by the CMA in its final



determination (which dealt with the entire length of circuits, rather than dividing out main links and access segments).

33. In the final determination, the CMA determined that ‘TalkTalk’s use of 5km and 10km circuits lengths ... appears to be reasonable’.<sup>14</sup> We assume that the discrepancy between treating a length of 5-10km as ‘typical’, and Ofcom’s approach in the consultation document where it adopts a figure of 1.9km, is a result solely of the exclusion of main links from the analysis. However, it would be helpful if Ofcom could confirm this is the case, and provide assurance that Ofcom’s figures result in circuit lengths which are consistent with the CMA’s findings.

**A more robust approach to assessing the length of main link segments will be possible in future**

34. We think Ofcom has made a reasonable assumption, in multiplying the radial distance of circuits in BT’s inventory by 1.4 to estimate the actual route length for access segments. This is the same figure adopted by the CMA, and it roughly reflects the figure generally used for network planning purposes.
35. However, Ofcom has assumed that main link segments are straight (i.e. it has assumed the radial distance is the same as the route distance). It may be reasonable to assume that – for longer routes, such as main links – the difference between the route length and the radial length will be less than for shorter distances. However, clearly they will not be the same since Openreach does not simply lay cables between two points ‘as the crow flies’. Cables must follow ducts, which typically are constructed along roads and footpaths (and, indeed, in many cases the route length may be significantly longer than the radial length).
36. In future price controls, there should be some allowance for this. The PAG can understand that Ofcom has adopted an overly simplified assumption that the radial and route distances are the same, given the circumstances of the appeal and the timing of Ofcom’s consultation document. However, the PAG would urge Ofcom to provide assurance that, as the rollout of DFA occurs, it gathers data and performs a proper analysis to determine an appropriate route length to adopt for main links in future.

**Adopting the median, rather than the mean, figure**

37. The PAG also questions whether it will be appropriate to ignore the mean length of circuits in future price controls. Although the figures are marked confidential in the consultation document, Ofcom strongly implies that the mean length of circuits is significantly greater than the median length. It adopts the median on the basis that “the median is more representative than the mean in this case, as it avoids distortions which could be created by a small number of very long circuits”.<sup>15</sup>
38. However, this is only appropriate if Ofcom can demonstrate that, those very long circuits would not be taken up as dark fibre. If Ofcom’s future information gathering

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<sup>14</sup> CMA final determination, para 4.72.

<sup>15</sup> Condoc para 2.27.

does not bear out this assumption, then longer circuits should remain part of the analysis.

39. We think this approach would be more consistent with the CMA’s final determination, which took into account both the median and the mean length. Specifically, the CMA said that:

*“We also understand that approximately [redacted]% of circuits have a route distance greater than 10km, and therefore the mean length is likely to be considerably greater than the median length. Accordingly, TalkTalk’s use of 5km and 10km circuit lengths ... appears to be reasonable”.*<sup>16</sup>

40. The rollout of DFA will provide an opportunity for Ofcom to test the appropriateness of simply ignoring the mean length of circuits. Again, this is an issue which will require a careful and more robust rethink going forward.

## Recovery of BT’s costs

41. Ofcom has also made adjustments to the LLCC, which it claims are necessary to account for the risk to BT’s cost recovery.
42. This issue needs to be addressed in the context where BT’s business connectivity services have been a source of extreme levels of profitability over many years, including returns more than double BT’s WACC on a regular basis – and in some cases around three times BT’s WACC. This is illustrated by Ofcom’s own analysis:<sup>17</sup>



43. Ofcom itself has acknowledged that there is a fundamental problem with BT over-recovering:

<sup>16</sup> CMA Final Determination para 4.72.

<sup>17</sup> Final Statement, para 7.39, figure 7.1.

*“Although the 2013 LLCC has reduced BT’s profitability for Ethernet services, in the final year of the current control BT’s ROCE will still be more than double BT’s cost of capital. For TI services, BT’s ROCE has increased in each year of the 2013 LLCC. We consider that these high and persistent returns are exceptional...”<sup>18</sup>*

44. This demands that Ofcom carefully assess whether giving BT relief is proportionate and necessary. For this reason, we disagree that Ofcom should take a narrow and mechanistic approach to proposing adjustments – and to refuse to consider any other new information or the validity of any other assumptions in Ofcom’s initial decision. In particular, we are concerned that BT has an opportunity to over-recover its costs for ISDN services by more than £100m. We are also concerned that Ofcom has simply assumed that the incremental reduction in costs for BT, as an active circuit is migrated to DFA, will be the same as BT’s attribution of NDRs. However, there is no evidence that this is the case. Furthermore, when active WLR services were migrated to MPF, the reduction in costs enjoyed by BT was significantly greater than BT’s attribution of NDRs to WLR.
45. While Ofcom has taken the exceptional step of imposing starting cost adjustments in the LLCC, it has deliberately taken the choice to make such adjustments conservative and “to avoid values that would be based on attempting to strictly align BT’s revenues with costs (or with any specific mark-up on costs) in that particular year”.<sup>19</sup> Furthermore, Ofcom further set the LLCC and starting charge adjustments with a view to and aiming to avoid discontinuity in charges over time to promote predictability. That factor does not support changing the LLCC at this late stage, when CPs are developing business plans based on expected pricing. Given that Ofcom acknowledges itself that it built in a ‘margin of error’ for BT in the LLCC, it would now be appropriate to leave the LLCC as-is, in order to provide predictability and consistency for users of BT active business connectivity products.
46. If Ofcom insists on a LLCC adjustment, Ofcom’s decision must reflect that:
  - a) the existing network operators which pay NDRs using the R&E method will not be affected by Ofcom’s proposed decision; and
  - b) for all the reasons set out in this submission (unless the PAG’s suggestions are adopted in full) – DFA volumes will nevertheless remain lower than initially estimated in Ofcom’s Final Statement, which assumed that government would change the rules for NDR liability.

## **Cost-benefit analysis**

47. The PAG agrees that the approach adopted by Ofcom should approach the outcome Ofcom originally intended to achieve: that is, to enable CPs to use dark fibre to compete with BT for 1Gbit/s services (and their decision to do so will not be materially distorted by NDRs).

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<sup>18</sup> Final Statement, para 7.40.

<sup>19</sup> Final Statement, para 7.55.

48. It follows that the PAG agree that, under an appropriately adjusted DFA pricing regime:
  - a) CPs will have broadly unchanged incentives to use dark fibre in place of active products, compared to the incentives set out in the Final Statement; and
  - b) Ofcom's initial assessment will have correctly set out and quantified the benefits and risks of dark fibre in its Final Statement and that no other changes to the remedies set out in the Final Statement are required or proportionate.
49. Accordingly, under an appropriate pricing regime, it would be unnecessary to conduct a new impact assessment and the results of any such assessment would be unchanged from the assessment already undertaken by Ofcom.