Zayo's Response to Ofcom's Consultation on Non-Domestic Rates and the Price for Regulated Dark Fibre

Introduction

Zayo Group is a global provider of communications infrastructure services, including dark fibre, wavelength, Ethernet and IP services. Zayo operates in the United States, Canada, France, Germany, Netherlands, Belgium, Switzerland, Italy, Ireland, and the United Kingdom. Its UK fibre optic network spans more than 450,000km and connects over 130 data centres via unique routes alongside the national gas pipeline and within London's sewer system. Zayo was founded in 2007 and is headquartered in Boulder, Colorado, with European headquarters in London and Paris.

This consultation concerns the pricing of the Dark Fibre Access ("DFA") remedy which Ofcom imposed in its April 2016 Statement following its review of the Business Connectivity Market ("BCM"). Ofcom decided that the DFA price should be calculated on an "active minus" basis, that is by subtracting an "active differential" from the price of the corresponding BT Ethernet 1Gbit/s leased line (EAD) service.

Ofcom proposed that one component of that active differential should be a deduction of BT's non-domestic rates ("NDRs") associated with the corresponding active service. This decision was appealed and in April 2017 the CMA determined that Ofcom was wrong to decide that this component of the active differential should be based on an attribution of *BT's* NDR costs and required Ofcom to amend its approach in accordance with its regulatory objectives and taking into account the CMA's findings in this determination[1].

In this consultation, Ofcom is proposing to adjust the NDR component to reflect the higher NDRs paid by some CPs for dark fibre products and to base the NDR component on the NDRs payable by a CP with a contiguous fibre network of 1,000 km or more, assuming an average route length of 1.9km.

This adjustment will result in a reduction in the price of the DFA products, leading to a reduction of associated revenues to BT. To reflect these reduced revenues, and to ensure that BT is able to recover its costs, Ofcom has made an adjustment to the Leased Lines Charge Control ("LLCC") by decreasing the value of X in 2018/19 from -13.50% to -12.75%.

Ofcom has posed a single consultation question.

Do you agree with our proposal for the adjustment of the price of dark fibre to take into account the NDRs paid by CPs and our assessment of its impact on the costs and benefits of dark fibre? If not, please set out your reasoning, including supporting evidence, and explain: (i) how Ofcom should approach making the adjustment to the price of dark fibre in a manner which takes into account the Determination, and (ii) how that alternative approach would impact on the costs and benefits of dark fibre.

[1] CMA Determination, paragraph 6.21

Zayo does not agree with Ofcom's proposal, for the following reasons:

- Ofcom has not taken account of all of the CMA's findings in its determination
- Ofcom has failed in its duty to undertake an analysis of the wider impacts on competition of its proposed adjustment, in particular the likely impact on infrastructure competition
- The DFA price resulting from Ofcom's NDR adjustment will increase the negative impact on infrastructure investment incentives
- the inclusion of any NDR element to calculate DFA pricing will result in a distortion of competition

<u>Ofcom has not taken account of all of the CMA's findings in its determination</u>

In addition to finding that Ofcom was wrong to decide that the NDR costs to be deducted from the EAD price in deriving the DFA price should be an attribution for BT's rates costs, the CMA also found that Ofcom underestimated the impact of the LLCC on competitive investors in infrastructure.

The CMA expressed the view that CityFibre had "identified a credible case that it will be affected by the scale of the price reduction in the LLCC" and that it was "likely that the reduction in leased line charges could have a similarly detrimental impact on other infrastructure providers"[2]. The CMA therefore concluded that the LLCC is likely to have an effect on the pace of investment in competing networks.[3]

The CMA also concluded that

> "… Ofcom could have chosen to take more account of spill-over benefits in setting the LLCC. However Ofcom's judgement was that the direct link between investment in fibre rings for business connectivity and future residential roll-out was weak. In its view it was better to address the potential benefits of fibre roll-out directly through its regulation of the FAM, rather than indirectly through the LLCC."[4]

We believe that Ofcom's argument has been further undermined by its proposal, published since this consultation, to permit a 'mixed usage' approach to Physical Infrastructure Access ("PIA") whereby, provided PIA is used to deploy a broadband access network to residential and SME consumers at scale, the same network may also be used to deliver leased line services[5].

Ofcom's preference has been not to use the BCMR to promote competition in residential broadband markets. In Zayo's view, this "silo" approach to regulation is becoming increasingly unsustainable. Ofcom's market review analyses frequently fail to reflect current market realities of hybrid and mixed use networks with the result that Ofcom has been failing in its duty effectively to promote competition by encouraging competing network infrastructure.

The CMA's Determination concluded the following[6]:

> "(a) there would be likely to be benefits from innovation and stronger competition in the BCM if an alternative cost standard led to increased infrastructure competition;

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[2] CMA Determination, paragraph 3.81
[3] CMA Determination, paragraph 3.82
[4] CMA Determination, paragraph 3.128
[5] Zayo remains opposed to *any* restriction on usage of PIA as any such restrictions, even the "mixed usage" approach, fails to create a competitive level playing field, creates regulatory uncertainty and therefore acts as a disincentive to investment
[6] CMA Determination, paragraph 3.141

(b) the benefits in the BCM would be linked to quality and innovation in customer offering, rather than a step-change in technical capability of the technology offered by CityFibre relative to BT;

(c) there are material benefits associated with fibre investment in the markets characterised by Ofcom as the FAM, and these could form part of the benefits from investment in competing infrastructure …"

The CMA stated that, when considering further the pricing of DFA, it would "expect that Ofcom's consideration would be made in light of all the relevant circumstances"[7]. It is therefore Zayo's view that Ofcom should not have considered revisions to the DFA remedy in this consultation without also revisiting its assessment of the impact on infrastructure competition.

The CMA's ruling required that "Ofcom should determine an *amended DFA pricing methodology* in accordance with its regulatory objectives"[8]. We do not consider that the adjustments Ofcom have made amount to a change to the overall DFA pricing methodology, but rather an adjustment to a single component.

<u>Ofcom has failed in its duty to undertake an analysis of the wider impacts on competition of its proposed adjustment, in particular the likely impact on infrastructure competition</u>

Ofcom's proposed adjustment effectively amounts to a price reduction for the DFA product. Ofcom has made an adjustment to the Leased Lines Charge Control ("LLCC") in order to reflect the reduction in *revenues* that BT will receive, assuming consistent volumes. However, it has not performed an analysis on the impact this adjustment will have on DFA *volumes* and any LLCC adjustment that should flow from the conclusions of such analysis.

We believe that this price reduction will result in higher take-up of the DFA product, at the expense of dark fibre offered by alternative infrastructure investors. We therefore would have expected Ofcom to request data from the market in order that it could perform a reasoned cost/ benefit assessment of the impact of this decision. We would also have expected Ofcom to request data from the market regarding circuit lengths, in order to assess average lengths per CP. Ofcom has failed to perform such analysis.

<u>The DFA price resulting from Ofcom's NDR adjustment will increase the negative impact on infrastructure investment incentives</u>

The reduction of approximately £200 in the DFA price will bring the DFA price down to a level where no competitive providers are likely to be able to achieve a satisfactory rate of return to justify continued investment in competing fibre infrastructure in the UK.

Zayo has always opposed Ofcom's "active-minus" approach to DFA pricing because of the adverse impact on infrastructure competition that will result, and this decision on the NDR component only increases our concern.

In Zayo's view, the proposed DFA pricing structure already undervalues the cost of investing in fibre. This further price reduction will make it extremely difficult to justify any new network construction.

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[7] CMA Determination, paragraph 3.252

[8] CMA Determination, paragraph 6.21(a)

The inclusion of any NDR element to calculate DFA pricing will result in a distortion of competition

The difference between the cost attribution of BT's NDRs to leased lines and the level of OCPs' NDR costs for comparable services is known as the "NDR Differential". Ofcom is proposing a single adjustment to the DFA price for all qualifying CPs[9] regardless of the size of their existing network or length or location of their circuits. Ofcom acknowledges that "… in some cases the NDR differential will be higher than that necessary to offset the actual NDR payment a specific CP would face on any given circuit, and in some cases it will be lower."[10]

Ofcom expressed concern in its BCMR Final Statement that "any differences in the NDRs payable by different CPs in using the same regulated dark fibre circuit from Openreach could frustrate the design of the DFA remedy we have decided to introduce".[11]

We believe that Ofcom has failed in its duty to undertake a reasoned analysis, based on data provided by stakeholder CPs, of the impact of this decision on DFA take-up based on an assessment of the level of competitive distortion that inclusion of the NDR element will create. This failure will result in regulatory uncertainty and market instability.

Reform of the Rating Regime

In its determination, the CMA found that "there is a material differential between OCPs' NDRs and the attribution of BT's NDRs in respect of the significant majority of circuits"[12].

This confirms what the industry has collectively been saying for more than a decade – that the regime for levying rates on fibre networks is iniquitous, creates a distortion of competition and may well constitute unlawful State Aid.

We acknowledge the fact that Ofcom does not have any responsibility for the rating regime. However, we find it extremely troubling that Ofcom proposes to require BT to launch a DFA product which has such competitive distortions built in. We consider that this brings into question the extent to which Ofcom is able to discharge its duties in introducing this remedy.

Moreover, we urge Ofcom to bring its influence to bear in the wider policy debate about how to increase investment in fibre infrastructure by removing barriers to investment such as the levying of NDRs on fibre networks and the application of discriminatory rating regimes amongst industry participants.

Zayo, May 2017

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[9] Qualifying CPs are those whose NDRs are assessed using the DRC method.
[10] Ofcom consultation, paragraph 2.60
[11] BCMR Final Statement, Annex 23, paragraph A23.110
[12] CMA Determination paragraph 4.77