Wholesale Local Access Market Review

TalkTalk response to Ofcom consultation paper on recovering the costs of investment in network expansion

September 2017

NON-CONFIDENTIAL VERSION

1 Summary

1.1 This document is TalkTalk's response to Ofcom's consultation dated 9 August 2017, on *Recovering the costs of investment in network expansion*.

1.2 TalkTalk supports the Government's ambition to ensure that all UK residents have access to high-speed broadband of at least 10 Mbps by 2020. Good-quality broadband is a necessity for households to be able to engage fully in society– it is just as much a utility as the ability to make and receive phone calls. For too long, too many households, particularly in rural areas, have remained in not spots: areas with broadband connectivity that does not allow citizens to adequately engage with the range of services available online. It is imperative that over the next few years this situation is remedied, and all homes and businesses in the UK are provided with a good baseline level of connectivity.

1.3 However, TalkTalk considers that Ofcom's current consultation is incomplete, inappropriate, and misconceived. In this response we set out serious concerns about the substance of the proposals themselves and the process Ofcom has followed in developing its consultation proposals, including the lack of consideration of a number of necessary factors.

1.4 This consultation implements a universal service obligation (USO) in all but name – BT would be investing in providing unviable extended coverage in return for external subsidy. The restrictions engaged in the Universal Service Directive (USD) therefore apply.

1.5 The proposed investment in network expansion is not commercially viable or commercially normal. BT did not propose to make this investment at a time when it was not subject to price cap regulation, and therefore had to bear the commercial risk of the investment. Rather BT is only making the investment now that the future regulatory regime will deliver guaranteed funding. Indeed, BT refused to consider commercially investing in areas which were considerably <u>more</u> profitable than the regions now under consideration, and instead received substantial public subsidy to cover their costs. The provision of that public subsidy was, correctly, assessed as State Aid by the European Commission.[1] The fact that BT sees a need for an 'agreement' with DCMS before engaging in this investment, and has publicly stated that it will not invest unless it has certainty that it will fully recover its investment, are further indications that the network expansion is not commercially normal.

1.6 If the investment is not commercially normal and is being provided as part of an agreement with either Government or the regulator, then the USD applies irrespective of whether BT's agreement with DCMS is described as implementing a 'regulatory USO' or a 'network expansion'.

1.7 These proposals are radical and, if implemented, risk both undermining the independence of Ofcom and significantly distorting the market for

[1] http://ec.europa.eu/competition/state_aid/cases/263954/263954_1760328_135_4.pdf

telecommunication services within the UK. Yet the Consultation contains insufficient analysis of either the effect or the appropriateness of Ofcom's proposals. In particular:

- no consideration is given to whether it is legally appropriate for Ofcom to take into account an agreement which it is not, itself, a party to, and has played no part in negotiating;
- there is no assessment of whether the proposals conform to the spirit or the letter of the USD, and thus whether they are consistent with current European law. In our view the proposals are incompatible with the USD;
- there is no assessment of whether funding the agreement between BT and DCMS should be done through WLA charges before investment has taken place, after investment has taken place, or through a different mechanism entirely;
- there is no meaningful assessment of the likely distortion of competition between different operators, which may be significant;
- there is an incomplete assessment of the indirect benefits accruing to BT Retail, as is required by the Universal Service Directive;
- Ofcom has not sufficiently addressed the issue of whether its proposals would fund overbuild of current or proposed developments by altnets such as Gigaclear and Hyperoptic, and how that could be prevented;
- although Ofcom states that it will require a 'clear and public' agreement between the Government and BT, no mechanism is proposed for assessing what constitutes sufficient clarity, nor for whether the agreement is legally binding;
- there are no proposals presented by Ofcom for any clawback or price cap reductions in the case that roll-out proceeds more slowly than BT currently proposes, or does not proceed at all; and,
- Ofcom has not taken into account the prospect that there could be further BDUK roll-out, funded by clawback mechanisms, which could substantially reduce the number of premises for which BT could be required to fund increased speeds.

1.8 The analysis is not sufficiently transparent to allow for proper scrutiny and also contains what appear to be a number of factual errors, further undermining Ofcom's ability to rely on the consultation:

- analysis undertaken on behalf of TalkTalk by Plum Consulting indicates that BT's cost estimates are overstated, and Ofcom's estimated £546m cost is also in excess of all of the modelled scenarios;
- Ofcom's modelling of Long-Reach VDSL ('**LR-VDSL**') confusingly finds that LR-VDSL increases, rather than reduces the cost of serving deep rural customers, a result which is counterintuitive and conflicts with Plum's analysis;

- the approach adopted breaches the generally accepted methods of cost allocation, where costs are allocated to the regulated product which causes them to be incurred.

1.9 Ofcom's current consultation, notwithstanding whether it should be taking place at all, is not fit for purpose. The consultation does not consider a wide range of factors which could lead to a finding that the additional funding provided to BT Group is either excessive, or should not be provided at all. It would not be appropriate for Ofcom to provide any funding to Openreach for further network developments on the basis of the current, flawed, consultation.

1.10 In addition, we note two serious procedural errors.

1.11 First, Ofcom's substantive consultation factors in an assumed agreement between DCMS and BT at a time when there is no public written offer from BT, let alone an agreement.[2] Indeed, even in the event that BT submits a written offer that is made public, the Government has not yet decided in principle whether it could accept such an offer– this is dependent on the outcome of a DCMS consultation on a regulated USO which does not close until after the closure of Ofcom's consultation– or would instead use some other approach to delivering universal access to broadband of at least 10 Mbps.

1.12 In light of this, Ofcom cannot rely on its current consultation when undertaking its final WLA decision, as it does not contain sufficient detail to fulfil Ofcom's public law obligations to consult. Rather, in the event that BT and DCMS reach an agreement, Ofcom should then, and only then, consult on whether that agreement should be reflected in the WLA charge control. If this comes after the point at which Ofcom has notified its WLA proposals to the European Commission, then Ofcom should, as part of this further consultation, consult on whether funding for network expansion should be included within any WLA charge control. In the event that it concluded this was appropriate, Ofcom would also need to consult on whether it should be included in the 2018 WLA charge control, or should be held over until the 2021 WLA charge control.

1.13 Second, TalkTalk considers that the offer being made to Government by BT Group, without the leadership of the Openreach Board, constitutes a *prima facie* breach of BT's revised commitments to Ofcom for Openreach to operate as a legally separate and independent company:

- major capex investments by Openreach are not a matter for the BT Group CEO to directly determine. Rather, they should be proposed and agreed by the Openreach CEO and Board, without BT Group consideration unless they go outside Openreach's agreed capex envelope;
- Openreach should be managing its relationship with Government itself and should not be 'outsourcing' it to BT

[2] The only information available about BT's proposal is provided in a DCMS press release: https://www.gov.uk/government/news/universal-broadband-to-reach-every-part-of-the-uk

- Openreach should not be entering into major capex commitments without formal consultation with its customers. No such consultation has been entered into in this case.

1.14 TalkTalk plans to shortly make a formal complaint to Ofcom that the potential deal between DCMS and BT, and in particular the manner in which it has been undertaken, breaches Openreach's revised obligations.

2 The Universal Service Directive applies to this consultation

2.1 Ofcom's proposals appear to be written from the basis that the Universal Service Directive does not apply, because Ofcom and the Government are describing this as an 'agreement' or a 'universal broadband proposal' rather than a 'universal service obligation'. This is wrong. The substance of the proposals is such that they implement a USO, and as such the constraints of the USD apply.

2.2 A crucial legal omission is that Ofcom has failed to analyse the interaction of the Access Directive and the Universal Service Directive. The Access Directive seeks to secure access to networks, so as to allow CPs to offer competing services. The USD provides for network expansion beyond what is commercially justified to ensure all parts of the population have access to essential services.

2.3 The USD sets out the conditions under which there is a universal service obligation imposed, before going on to specify the way in which a universal service provider must be designated and its obligations supported. As set out in paragraph 4 of the preamble to the USD:

> *Ensuring universal service (that is to say, the provision of a defined minimum set of services to all end-users at an affordable price) may involve the provision of some services to some end-users at prices that depart from those resulting from normal market conditions. However, compensating undertakings designated to provide such services in such circumstances need not result in any distortion of competition, provided that designated undertakings are compensated for the specific net cost involved and provided that the net cost burden is recovered in a competitively neutral way.*

2.4 '*Compensating undertakings designated to provide [the provision of some services to some end-users at prices that depart from those resulting from normal market conditions]'* is precisely the situation in the current case. Normal market conditions would not supply speeds in excess of 10 Mbps to customers where the cost of upgrading to these speeds exceeds £1,000 per premises.[3] Therefore this network expansion is exactly the type of investment that is intended to engage the USD. Thus it follows that BT should be designated to provide such improved broadband speeds under the USD, and that the method chosen to fund the cost is consistent with the

[3] The Plum report, at Figure 4.1, shows that the total cost of provision in the case where LR-VDSL does not prove effective is £489m for 450k premises, or £1,087 per premises.

USD, for instance by not distorting competition. As paragraph 18 of the preamble goes on to say:

> *Member States should, where necessary, establish mechanisms for financing the net cost of universal service obligations in cases where it is demonstrated that the obligations can only be provided at a loss or at a net cost which falls outside normal commercial standards. It is important to ensure that the net cost of universal service obligations is properly calculated and that any financing is undertaken with minimum distortion to the market and to undertakings, and is compatible with the provisions of Articles 87 and 88 of the Treaty.*

2.5 It is clear that the cost of upgrading households in the last 3% of the country to speeds above 10 Mbps– a cost which in some cases will be £3,000 or more per household– is well outside 'normal commercial standards'. That implies that the financing mechanism should be undertaken with regard to minimising competitive distortions, and in accordance with a net cost approach. As set out elsewhere in this paper, Ofcom does not seek to minimise distortions, and does not properly apply a net cost approach.

2.6 It appears from its previous consultation responses that BT also agrees that there are substantial areas of the country where it will not be commercially viable to roll out 10 Mbps broadband, and that these should be funded via a USO:

> *The current approach to the voice USO, based on an assessment that BT (and KCOM in Hull) derive more benefit than the cost of supporting a voice USO would not be appropriate in our view for a UK wide broadband USO scheme. All the evidence we are aware for the areas where a commercial deployment will not be viable for good broadband shows that these areas are very expensive to provide, have limited technical options available, and are in areas where it is clear that the costs to any provider at the network build level of providing a viable USO scheme would far outweigh the additional benefits achievable as a result of deploying any new infrastructure. A process that aligns more with that used in other countries for USO's whereby costs a USO provider is reimbursed for the additional costs of provision would need to be established, in those areas where a USO was deemed necessary*[4]

2.7 Although BT is not clear which parts of the country it considers not viable for a commercial deployment, it would be unlikely to have written this section if they were minimal in scope. TalkTalk's interpretation of this section is that BT itself was indicating that a USO would be necessary for the areas of the country which are subject to the potential agreement between DCMS and BT.

2.8 In addition to the above analysis, there are a number of further indications that Ofcom's proposals are in fact the implementation of a USO, and do not represent normal commercial practice, irrespective of how Ofcom chooses to term the proposed agreement between DCMS and BT.

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[4] BT (2016), *Response to the Ofcom call for inputs on: "Designing the broadband universal service obligation"*, at page 18

2.9 *There is a proposed deal between DCMS and BT*–BT does not enter into negotiations with DCMS before every major network investment which it undertakes, and certainly does not seek a formal agreement before doing so. The fact that BT has been engaged in detailed negotiations with DCMS prior to committing to network expansion demonstrates that this investment is not commercially the same as others which BT undertakes.

2.10 *BT has indicated that it will only go ahead with network expansion in the event it secures an agreement with DCMS*–BT has indicated that it will only proceed with an upgrade of all customers to 10 Mbps (in the absence of being designated as a USO provider) in the event that it successfully reaches an agreement with DCMS and WLA charges are increased, and will not go ahead with its investment in the absence of such an agreement.

2.11 *The proposed agreement between DCMS and BT is a substitute for introducing a formal USO*. DCMS makes it clear in its press release on the potential agreement with BT that the agreement and formally implementing a regulatory USO are alternatives which fulfil the same purpose:

> *Homes and businesses from all parts of the UK are set to benefit from universal high speed broadband, Culture Secretary Karen Bradley announced today. BT has put forward an offer to voluntarily provide this service across the country, which would largely be delivered by Openreach. The offer has been received after the government committed to introduce a Universal Service Obligation (USO) through regulation to give every home and business in the UK the right to request a high speed connection… [The consultation] will help Government take a decision on the best way to get better broadband in hard to reach areas. No decision has been taken, and the Government will carefully weigh the merits of the two approaches*.

2.12 This is clear that the Government is weighing a formal USO against an informal USO via the agreement between DCMS and BT. The two options are alternatives for one another, and the decision as to which to adopt will be taken on which better meets the Government's objectives.

2.13 *A formal USO and the proposed agreement contain the same key features*– the USO option as set out in DCMS's July 2017 consultation, is based around 10 Mbps download speeds, 1 Mbps upload speeds, and a series of other quality elements.[5] The accompanying press release from DCMS, setting out the terms of the potential agreement between DCMS and BT, states at footnote 2 that the same terms will apply to BT's offer. Consequently they are fulfilling the same features as one another, with few practical differences in the outcome for consumers.

2.14 *The proposed agreement between DCMS and BT covers a range of areas which may alternatively be funded through the BDUK scheme*– the BDUK scheme is intended to cover areas which are not commercially viable for investment in the absence of state subsidy. It began by covering the areas which were marginally unviable for commercial investment, before moving on to subsidise progressively less

[5] DCMS (2017), *A new broadband Universal Service Obligation: consultation on design*, at page 3.

commercially viable areas. The remaining areas which do not have access to at least 10 Mbps broadband– the last 3% of UK premises– are by definition less commercially viable than around 30% of the country which has previously received state funding. Roll-out to the last 3% is not viable for investment on commercially normal terms, and is less commercially viable than areas where BDUK has, in the past few months, been recycling clawed back funding to support commercially unviable areas.

2.1 BT's proposed agreement with DCMS is not commercially normal

2.15 Given these facts, there is no credible argument that BT's investment is commercially normal, in the sense that it would be undertaken by a firm operating in a competitive marketplace, and which could not rely on cross-subsidy from other parts of the country due to operating as a monopoly under nationally based price regulation. There are a wide range of indications that BT is proposing to enter into this agreement primarily because of Ofcom's regulatory forebearance, and not because it would be profitable for a stand-alone company operating in an unregulated market to make the investment.

2.16 In the event that BT's proposed investments in network expansion are not commercially normal, then as is set out above and at §§4.10 *et seq.* below, the Universal Service Directive must be adhered to. Ofcom cannot simply rename a USO as 'network expansion' in order to avoid applying the USD to its proposals. The determination of whether the USD applies must be made on the basis of the objective factors set out at §4 of the preamble to the USD.

2.17 Therefore, as the proposed agreement between DCMS and BT is not commercially normal, the Universal Service Directive is applicable to the agreement. Section 4.2 below sets out the various implications of this for the analysis which Ofcom has to conduct and the process for determining which firm should be designated as the USO provider.

3 Ofcom should not be undertaking this consultation

3.1 This section sets out the reasons why Ofcom should not, at the current time, be consulting on whether and how to include the costs of any agreement between BT and DCMS in the WLA charge control. The primary reasons why Ofcom should not be consulting now are as follows.

3.2 ***There is no formal offer from BT***– in general, where a major change to price caps was being proposed due to an agreement between the Government and BT, then the formal agreement (or in rare cases, proposed agreement) should be published for stakeholders to be able to view. Not only has there been no such publication, but Ofcom does not even set out in its consultation that it has seen the detailed offer. In the absence of such a written offer which has been scrutinised by Ofcom, it is inevitable that Ofcom's consultation will be so vague that it would be unlikely to meet Ofcom's public law duties to consult on the substance of its proposals.

3.3 The lack of clarity in the consultation can be seen in the ranges for proposed additional charges as a result of any agreement which is reached. In each of the years of the charge control, Ofcom proposes ranges as follows:

- 2018/19: £0.23 to £1.57
- 2019/20: £0.71 to £3.80
- 2020/21: £1.14 to £5.89

3.4 As can be seen from the above, the top end of the range in 2018/19 is 582% higher than the bottom end; in years two and three the ratio is 435% higher and 416% higher respectively. This does not meet Ofcom's public law obligation to undertake an effective consultation– the range is so great that Ofcom is, in effect, saying that it can do whatever it likes to prices following on from agreement between BT group and DCMS.

3.5 ***DCMS has not decided whether it would accept BT's offer, even in principle***– Ofcom's consultation can only be relevant if there is an agreement between BT and DCMS which will definitively lead to improved broadband for customers currently unable to receive 10Mbps download speeds. However, DCMS has not yet even closed its public consultation which will feed into its decision as to whether it could accept such an offer. It is therefore premature for Ofcom to consult on the inclusion of the costs of any agreement between BT and DCMS, as it effectively prejudges the outcome of the DCMS consultation, and potentially wastes resources of both Ofcom and stakeholders in the event that DCMS decides not to go ahead with this approach.

3.6 In the absence of a written offer which has been assessed in detail by Ofcom and which DCMS has stated that it is minded to accept, it is not possible for Ofcom to set out a sufficiently specific consultation in order to meet its public law duties to provide sufficient information in its consultation document to ensure that the consultation process is fair.

4 The consultation paper is flawed

4.1 Section 2 set out the reasons why Ofcom should not be undertaking a consultation on BT's 'offer' at the current time. This section moves on to consider why, even if Ofcom did not accept the argument in the prior section, the consultation is flawed within its own terms, and as such is not fit for purpose.

4.1 There is no legal assessment of the proposals

4.2 In its consultation documents, Ofcom generally provides a legal assessment, demonstrating why, in Ofcom's view, the proposed measures are consistent with the legal structures under which Ofcom has to operate. This is important because in the absence of such an assessment, it is not clear under which legal basis Ofcom is taking its decision, and it is also unclear whether Ofcom has considered all of the relevant pieces of legislation. Indeed, the mere act of constructing a legal analysis section incentivises Ofcom to conduct appropriate legal analysis

4.3 Ofcom has not undertaken such an analysis in the current consultation. Indeed, its legal assessment is so cursory that it can be quoted in full below:[6]

> *The regulatory framework for market reviews is set out in UK legislation and is transposed from five EU Directives. These Directives impose a number of obligations on relevant regulatory authorities, one of which is to carry out periodic reviews of certain electronic communications markets.*
>
> *We have set out the relevant regulatory framework in our March 2017 WLA Consultation and reference should be made to that document for further detail.*

4.4 This is inadequate. Such a brief legal analysis could only be sufficient in the case where the consultation raised no additional issues beyond those in the initial consultation. For example, if Ofcom had proposed to amend its cost of capital estimate, but was undertaking no other changes to its initial consultation, then such a reference might be appropriate. However, Ofcom's 9 August consultation is fundamental, and raises significantly different legal issues from the initial WLA consultation.

4.5 In particular, there is no reference to the Universal Service Directive in Annexes 5 or 6 of the March 2017 WLA Consultation, which dealt with the legal regulatory framework pertaining to the WLA.[7] However, these are fundamental in considering whether Ofcom should make any change to its proposed WLA price caps as a result of any agreement between BT and DCMS. Ofcom should have considered the consistency of its proposals, and those of DCMS, with the Universal Service Directive as part of its consultation.[8]

4.6 Ofcom has also failed to consider whether any agreement between DCMS and BT, if taken into account in WLA price caps, is consistent with either European State Aid law, or with the various public procurement directives, as the increased price caps to BT are based on an agreement between BT and the Government. [9] This is particularly important given the reference in the Universal Service Directive to ensuring that arrangements are compliant with Article 87 EC.

4.7 Ofcom's has not analysed whether the investment in network expansion should be considered to be efficient. This is despite stating that:

> *In meeting its proposed network expansion, BT will incur costs to expand its fibre access network footprint, and will provide customers the opportunity to purchase*

[6] Ofcom consultation, §§2.10-2.11.

[7] Beyond a reference to the meaning of the term 'USO' in the glossary.

[8] Directive 2002/22/EC

[9] For example, Ofcom should have considered the consistency of its proposals with all of the elements of Directive 2014/24/EU. It should also consider whether any agreement between BT and DCMS amounts to a concession within the meaning of Directive 2014/23/EU, and if so whether its proposals are consistent with that Directive.

> *superfast broadband services. <u>As with any network expansion, we would look to allow efficiently incurred costs in the charge control for services associated with that network expansion</u>. Where we are setting a single national wholesale price, we would then look to include the cost of the network expansion in the aggregate cost of providing the service. We therefore believe that, in principle, the costs of expanding BT's fibre access network to deliver its universal broadband proposal could be included in services covered by the WLA charge controls.* [Emphasis added]

4.8 However, there is no analysis beyond this of whether the costs in the currently proposed network expansion should be considered to be efficient, or whether, since they would never be undertaken commercially, they are inefficient and should be disallowed. Rather, Ofcom's statement appears to assume that the costs of *any* network expansion are recoverable through WLA charge controls, so long as the costs themselves are not excessive for the work done. As a result it has failed to set out the principles it uses or proposes to use to determine what investments are recoverable under SMP charge control and how these apply to the current proposal. This is a crucial omission that risks undermining much of the economic framework of regulation.

4.9 Finally, Ofcom has also failed to consider whether, even if all of the above were fulfilled, it can legally accept an agreement between DCMS and BT Group as being binding on Ofcom. This is a novel area of law, and one which would benefit from detailed analysis. Such analysis is notably lacking from Ofcom's consultation paper.

4.10 Given the significant number of omissions from Ofcom's legal analysis, it cannot properly conclude that its proposals are legally valid. Ofcom has simply not given its proposals the level of legal scrutiny which is required, or allowed others to comment on the legal arguments that Ofcom intends to rely upon.

4.2 The proposals appear to contradict the Universal Service Directive

4.11 The Universal Service Directive ('**USD**') entered into force in 2002, and specifies the manner in which Member States of the European Union should designate a universal service provider, and the obligations of a provider which is designated in that way.

4.12 Analysis undertaken by and on behalf of TalkTalk indicates that Ofcom's proposals also do not comply with the letter of the USD:

- Article 3 of the USD states that regulators '*shall seek to minimise market distortions, in particular the provision of services at prices or subject to other terms and conditions which depart from normal commercial conditions*'. As set out in section 4.4 below, Ofcom has not sought to minimise distortions, particularly relative to Virgin Media, in its proposals.
- Article 8 of the USD states that where a firm is designated to hold universal service obligations '*they shall do so using an efficient, objective, transparent and non-discriminatory designation mechanism, whereby no undertaking is a priori excluded from being designated*'. Ofcom's

proposals, and DCMS's approach, does not allow for the prospect of any other firm being designated to supply a 10 Mbps service to rural areas, and so is in *prima facie* breach of this article. [✂].[10]

- Article 12 of the USD states that regulators shall '*calculate the net cost of the universal service obligation, taking into account any market benefit which accrues to an undertaking designated to provide universal service*'. Ofcom has not calculated such an appropriate net cost; rather, it has neglected the benefits accruing to BT Retail (the monopoly provider in most of the areas affected by the proposed speed upgrades) when calculating net cost, resulting in BT being over-remunerated for the proposed enhancements to speeds. Ofcom should take into account the benefits to BT Retail (and its trading brands Plusnet and EE) in the impacted areas when determining the net cost. For example, BT Retail may be able to earn higher margins on FTTC products in these areas than on copper-based products; the higher speeds may result in lower customer handling and complaints costs; and there may be an improvement in BT Retail's brand perception as a result of improved quality of service. Furthermore, there may be some marginal increase in BT Retail's volumes, due to customers who had not previously taken broadband due to very low speeds deciding to take it in light of the improved speeds available.
- Article 13 of the USD deals with the manner in which any universal service obligations should be financed. It sets out that where there is an '*unfair burden*' on a firm holding a USO, then a cost sharing mechanism should be determined, which will enable the universal service operator to be compensated for the net cost of its obligations. This sharing mechanism should minimise distortions across operators, and should be proportionate and non-discriminatory. Ofcom does not propose to finance BT's roll-out of improved broadband in rural areas in such a way. Rather, it proposes to omit Virgin Media from any funding of network expansion, meaning that the cost sharing mechanism is by its nature discriminatory and distortionary.
- Finally, TalkTalk notes that Ofcom does not propose, as mandated by Article 14(2) of the USD, to publish an annual report detailing the contributions made by TalkTalk and other ISPs towards the cost of the minimum 10 Mbps speed for all UK broadband subscribers. We consider that such a report would be helpful and aid transparency of the extent to which the last 3% of customers in the UK are being cross-subsidised by increased charges from the other 97% of UK consumers, as well as helping monitor the extent of competitive distortions caused by the omission of Virgin Media.

[10] TalkTalk considers that the findings at §11.5 of Ofcom's 16 December 2016 report providing technical advice to government are incorrect in light of current market circumstances.

4.13 It is vital that the USD is fully respected by any Ofcom decision; but, as the above analysis demonstrates, the current consultation does not pay any heed to it. Ofcom should conduct an analysis of the consistency of its proposals with the USD, and publish this analysis as an addendum to the current consultation.

4.3 There is no consideration of whether Ofcom should take any agreement between DCMS and BT into account when setting WLA prices

4.14 In its paper, Ofcom proceeds immediately to considering *how* an agreement between DCMS and BT should be reflected in price caps. It does not consider *whether* any agreement between DCMS and BT should be reflected in price caps.

4.15 This is a crucial omission from the consultation paper. In its absence, it is difficult for respondents to comment on or understand Ofcom's reasoning for including a specific uplift for the proposed agreement, rather than treating it in the same manner as other network developments. Effectively, Ofcom does not consult on this central aspect of its overall proposals for the funding of network expansion, and instead prejudges its position on this matter.

4.16 In particular, this is important because the proposed agreement between BT and DCMS does not meet normal commercial standards, but rather is an exception to those standards:

- the very fact that there needs to be an agreement between BT and DCMS, and that this agreement is subject to negotiation, indicates that this is not a normal commercial decision. In general, Openreach would independently take decisions regarding network developments (under its new arrangements, following suitable consultation with its customers) which it would then expect Ofcom to include within price caps at the next charge control for the affected products. That BT is finding it necessary to negotiate with government regarding this development indicates of itself that this potential phase of roll-out is not in any sense commercially normal;
- Ofcom issuing a consultation dealing specifically with this issue, and including it as an additional line item in its most recent general WLA consultation,[11] further indicates that this is not a normal development, but one which will only be entered into if BT receives concessions that it would not ordinarily expect;
- the areas in which BT is planning to build are also areas where BDUK may invest money clawed back from higher-than-expected takeup in previously subsidised areas. As BDUK is only intended to fund developments in areas where standard commercial development would be unprofitable, then by definition the areas which may be affected by the agreement between BT

[11] WLA Market Review: Further consultation on proposed charge control for wholesale standard and superfast broadband. September 2017

and DCMS are those in which commercially normal development would be unviable;

- moreover, BDUK invested its funding in the less expensive (and therefore more commercially normal) areas first. The areas which are being considered under an agreement between DCMS and BT are the *least* commercially viable parts of the UK– less commercially viable than other areas which have already received state subsidy.

4.17 For all these reasons, there is no plausible case that the areas which may be covered by an agreement between DCMS and BT are commercially normal, or commercially viable independent of special regulatory treatment. It would not be efficient for BT to undertake this investment unless there is a special cost recovery mechanism; indeed, as set out below this recovery mechanism involves recovering the costs of FTTC developments from MPF customers, in opposition to standard regulatory practice.

4.18 As any agreement between DCMS and BT will not be commercially normal, there is therefore a question whether the investments are efficient in an economic sense. It is plausible that, on the basis of a standard cost-benefit analysis, the costs of upgrading broadband for customers in the last 3% of the country may outweigh the benefits. If the benefits for these customers were higher than the costs, then these customers should generally be willing to self-fund infrastructure improvements. TalkTalk notes that Ofcom has not undertaken a cost-benefit analysis which demonstrates that the consumer benefits of any broadband improvements made as a result of agreement between DCMS and BT would outweigh the capital costs of investing in improved speeds. Ofcom should conduct such an assessment, and should consider whether the approach of including the costs of any agreement within the WLA is justifiable in light of the results of the CBA.

4.19 Given that the improvements to broadband for the last 750k customers in the UK would not be undertaken on a normal commercial basis, it would be appropriate for Ofcom to consider the extent to which the Universal Service Directive binds, in addition to its consideration of whether the investment is efficient and therefore should be included within the WLA price caps.

4.4 The proposals distort competition between operators

4.20 Ofcom's current proposals involve retail competitors being effectively divided into three categories with respect to how they will fund any agreement between DCMS and BT:

- those who will pay a higher external charge per customer through their wholesale charges for fixed line services. This category includes all external customers operating over the Openreach network, most notably Sky, TalkTalk and Vodafone (as well as the wholesale customers of TalkTalk and Vodafone);

- those who will not pay towards the agreement at all. This category includes firms other than BT which own their own fixed access networks, notably Virgin Media and Kingston Communications, but also Altnets such as Gigaclear and Hyperoptic;
- BT, who will not experience any incremental costs on a per customer basis as a result of the agreement, but will contribute the residual of any fixed costs net of contributions from Sky, TalkTalk and Vodafone, revenue uplifts and opex reductions across the BT Group as a result of the improved speeds in rural areas.

4.21 The difference between BT and Sky, TalkTalk and Vodafone results from the vertical integration of BT. The only way in which it could be prevented is if an operator other than BT undertook the network expansion. However, Ofcom's proposals worsen this distortion.

4.22 However, the decision to exclude Virgin Media from any funding of the potential agreement between DCMS and BT is a deliberate policy choice, which arises from the choice of using the WLA rather than alternative approaches. Under a USO funded by industry contributions, it is likely that Virgin Media would also contribute a sum per customer; however, this is not possible or considered under the current proposals.

4.23 It is indisputable that not including Virgin Media within funding of any agreement between DCMS and BT will distort competition between Virgin Media on one hand, and TalkTalk and Sky on the other. TalkTalk and Sky have to finance developments which will have no meaningful benefit to them, and which are unrelated to any actions which we have taken or not taken. This creates allocative inefficiency, as it will cause consumers to inefficiently switch away from TalkTalk and Sky, and towards Virgin Media, due to the higher costs that they will be charged for TalkTalk and Sky products.

4.24 The competitive distortion between TalkTalk and Sky, and Virgin Media, is completely ignored by Ofcom in its consultation– it is not even given a cursory assessment.[12] This is particularly surprising since Ofcom sets out at §6.11 of its consultation that creating effective competition is one of its six principles of cost recovery, and states at §6.13 of its consultation that it gives particular weight to ensuring effective competition; and that it is a stated principle of the Government's USO policy.

4.25 As part of Plum's analysis for TalkTalk, it has assessed the potential customer losses from other providers to Virgin Media if other operators pass on in full the increased charges which result from an agreement between DCMS and BT. Plum has estimated that where the agreement is funded through increases in WLA charges, and where LR-VDSL does not prove to be an effective technology, then Virgin Media will gain 75,000 customers as a result of Ofcom's choice to recover charges through the WLA,

[12] There are three references to Virgin Media in Ofcom's consultation, at §§3.14, 3.21 and 3.22, all of which are with regard to Virgin Media's network expansion plans.

with other operators losing the same number.[13] This indicates a significant potential competitive distortion between Virgin Media and other operators that cannot be merely assumed away, as Ofcom has done. Indeed, it is not considered at all by Ofcom in its analysis. It is unclear whether this is because Ofcom was aware of the potential for distortion of competition, and did not consider it relevant, or whether Ofcom was unaware of the distortion of competition because it did not consider it. Neither explanation is acceptable.

4.26 It is therefore imperative that Ofcom properly considers this distortion of competition before reaching its final decision on charge controls to reflect the potential agreement between DCMS and BT. It is not possible to say that it is appropriate to include the costs of such an agreement in the charge control unless such an assessment is undertaken.

4.5 Ofcom has not addressed the issue of potential overbuild of Altnet networks

4.27 In its consultation document, Ofcom does not consider whether there are any circumstances where the agreement between DCMS and BT might, by design or inadvertently, allow overbuild of Altnets' FTTP developments by BT. This is a significant omission, especially in light of Ofcom's strategic commitment to promoting infrastructure competition in FTTP following its Digital Communications Review.[14]

4.28 It is important that in Ofcom's final proposals on this matter, whether it proposes that costs should be recovered through the WLA or via an industry fund which finances a USO arrangement, the issue of potential overbuild of Altnets should be addressed and prevented. It would be inappropriate for predatory behaviour by BT towards Altnets to be financed through cross-subsidy from TalkTalk's customer base.

4.29 Ofcom should therefore decline to accept, and include in the WLA charge control (or fund via a USO) any agreement between DCMS and BT which does not include the most stringent protections against overbuild of Altnets. In particular, Ofcom should undertake a detailed consultation exercise, before BT's construction starts, to understand proposed and potential developments by firms like Gigaclear. It should then prohibit BT from overbuilding such areas; or, if this is not legally possible, claw back funding at penal rates to reflect any overbuild.[15] This is particularly important given the precedent for rural broadband programmes agreed between Government and BT to adversely impact Altnets. For instance, the Public Accounts Committee found that BT's lack of transparency in delivering the BDUK Programme " prevented

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[13] Plum report, Figure 5.1

[14] Ofcom, *Making Communications Work for Everyone – Initial conclusions from the Strategic Review of Digital Communications*, 25 February 2016: https://www.ofcom.org.uk/__data/assets/pdf_file/0016/50416/dcr-statement.pdf

[15] For example, reducing revenue through WLA price caps by three times the cost of construction in those areas. The clawback rate must be 100% to reflect the risk that Ofcom may not discover every area of overbuild.

other suppliers from developing proposals for schemes aimed at reaching the remaining 10% of premises that will be without superfast broadband".[16] It is critical that any agreement on the USO does not once again artificially prevent Altnets from playing their full role in the market.

4.30 The issue of potential overbuild is particularly important given the proposal that funding is via the WLA rather than a designated USO, which means that Altnets cannot compete for the opportunity to be the universal service operator in any area. This increases the risk of overbuild, as Altnets already planning to construct in a particular region may have found it particularly attractive to bid for a USO role in that area. It is therefore surprising that it is not considered in detail in Ofcom's consultation paper. TalkTalk considers this to be an important omission.

4.31 Overall, therefore, it is imperative that Ofcom includes strong safeguards against the risk of overbuild, and leaves BT to bear the risk of any overbuild which occurs.

4.6 BT's cost estimates are overstated

4.32 At §A8.21 of Ofcom's report, it sets out its estimate that the capex cost of an agreement between DCMS and BT will amount to £546m. This is broadly in line with BT's public statement that the cost of connecting the remaining UK households without access to 10 Mbps broadband will be £450m-£600m (although it is unclear exactly what BT has included in its estimate).

4.33 Based on the analysis undertaken by Plum Consulting for TalkTalk, we consider that these estimates are considerably too high. Plum's approach has been to consider the costs of what it terms the 'UBC' (effectively, the proposed deal between DCMS and BT) in two scenarios– one in which LR-VDSL proves to be an effective technology, and one in which it does not work. In each case, these scenarios are modelled on the basis of the model constructed by Plum on behalf of the Broadband Stakeholder Group. This model has benefitted from wide scale industry consultation, including from BT.

4.34 Plum estimates the gross costs of the potential agreement between DCMS and BT are:

- *if LR-VDSL can be used*: £213m;
- *if LR-VDSL cannot be used*: £489m.

Following adjustments to allow for a like-for-like comparison between Plum's estimates and Ofcom's, Plum's estimate is £500m without LR-VDSL.

4.35 Even in the case where LR-VDSL is not usable, Plum's estimate is over 8% lower than that of Ofcom. This is sufficient to make a meaningful difference to customers' bills and to the competitive distortion in favour of Virgin Media. In the cases where LR-

[16] P6, 'The Rural Broadband Programme', Public Accounts Committee, September 2013.

VDSL does become a proven technology, then Ofcom's estimates are overstated by a factor of around 2.5.

4.36 BT over-estimating costs in its FTTC roll-out has been previously seen in the BDUK roll-out. As set out in the NAO's report of July 2013, BT seriously overestimated the costs of its BDUK funded roll-out, and this appears to have continued with a further £180m of 'Project Efficiencies' identified in a recent DCMS press release.[17] On the basis of this previous evidence, combined with Plum's report, it would appear highly likely that BT has overestimated the costs of its potential agreement with DCMS.

4.37 BT has strong incentives to over-estimate its costs. By doing so, it can earn higher revenue from MPF and GEA products (as Ofcom appears to be providing BT with a fixed allowance, irrespective of actual outturn costs) which will flow directly through into profits. Furthermore, by doing so it will raise the costs of TalkTalk and Sky relative to those of BT Retail (which does not buy MPF, and for which the costs of GEA are an irrelevant internal transfer). There are no meaningful countervailing incentives which would disincentivise BT from increasing its cost estimates.

4.38 In light of this, Ofcom should carefully scrutinise BT's cost estimates, and be appropriately sceptical towards evidence of higher costs provided by BT. Both past experience, and Plum's evidence, point towards BT over-estimating its costs, and there are strong incentives for BT to do so.

4.7 Ofcom has failed to take full account of the indirect benefits to BT from the proposed agreement

4.39 Ofcom considers the indirect benefits derived by BT from its proposed agreement with DCMS at §§5.28-5.33 of its consultation, and at Annex 7. In summary, Ofcom estimates that there will be incremental wholesale benefits of £1m-£4m per annum over the charge control period from BT undertaking its investment, due to incremental GEA volumes.

4.40 At §5.33, Ofcom sets out that it does not propose to include any benefits which may accrue to BT at the retail level. It sets out its reasoning as follows:

> *The proposed network expansion will enable wholesale access to any telecom provider interested in providing the relevant service, so any benefits enjoyed at the retail level would be shared amongst telecom providers using the network (and would hence not be exclusive to BT). Estimating these benefits would required making a wide range of assumptions about retail pricing, margins, and market shares. We are concerned that if we were to do so we could disproportionately increase the risk of regulatory failure and fail to provide BT with the opportunity to recover efficiently incurred costs. Therefore, we have not sought to estimate and take account of potential indirect retail gains (costs) from our assessment of the costs of the proposed network rollout.*

[17] DCMS press release, *The Great British Broadband Boost*, 9 September, available at https://www.gov.uk/government/news/the-great-british-broadband-boost

4.41 There are a number of points to unpack in this rationale. The first, and most important, is that benefits enjoyed at the network level will be shared amongst telecoms providers using the network. While in principle this is correct, in practice there will be close to no sharing, because BT Retail's market share is so high in areas which will be affected by the DCMS/ BT proposed agreement. TalkTalk does not supply in areas where we have not unbundled the exchange already, [✂].[18] [✂]. We also understand that Sky has ceased sales to new customers in off-net areas, and Virgin is by definition not present in areas which might be subject to the agreement between DCMS and BT.

4.42 In its paper, Ofcom provides no evidence or data to suggest that the benefits at the retail level will be widely shared. There are substantial barriers to entry into the areas which will be impacted by the proposed DCMS/ BT deal, and in particular the need to set up suitable provisioning and customer support systems, and the substantial time needed, and costs required to be incurred, to acquire customers, particularly when they will have to be won from a dominant incumbent such as BT.[19]

4.43 Given the lack of major competitors in these areas, BT's retail market share will be consistent with that of a dominant operator. The retail level benefits from a DCMS/ BT agreement will therefore not be shared– the vast majority will be accrued by BT. If Ofcom wishes to claim otherwise, it should evidence its claim and conduct an appropriately detailed economic analysis, rather than rely on assertion.

4.44 The second element of Ofcom's rationale is that it would be complex to assess the retail market impact, and attempting to do so could disproportionately increase the risk of 'regulatory failure'. In effect, Ofcom is saying that they are concerned about the risk of undercompensating BT for its agreement with DCMS, and that this would constitute regulatory failure.

4.45 However, Ofcom does not consider the symmetric risk– that there is regulatory failure whenever it knowingly allows BT to make excess returns through overestimating its net costs. This is just as much a form of regulatory failure, and is particularly pronounced in the current instance where there is not just consumer welfare loss, but also distortion of competition as excess prices lead to substitution towards Virgin Media across the entire country, not just in the areas which gain from improved broadband speeds.

4.46 Once this risk is taken into account, it becomes clear that Ofcom will minimise overall welfare losses by making its best estimate of the gains to BT in the retail market, taking into account all of the complexities which Ofcom outlines in its consultation paper. The unavoidable level of uncertainty does not affect this– Ofcom should make its best approximation, rather than knowingly permitting BT to make supernormal returns. There is no self-evident reason why the welfare losses from

[18] Business Support System/ Operational Support System. Both are very large software systems which deal with issues such as provisioning and repairs to customers.

[19] In these areas, which largely correspond to WBA Market A areas, BT will be dominant at both the WLA and WBA levels of the market. If retail markets were defined on a sub-national level, in line with WBA geographic market definitions, it would also be found to be dominant at the retail level.

under-recovery should be greater than the welfare losses from over-recovery, and Ofcom has not cited any evidence that they are.

4.47 Such an approach would be aligned with the requirements of the Universal Service Directive, which requires indirect benefits to be taken into account.

4.7.1 *Plum's estimates of indirect gains to BT are considerably greater than Ofcom's estimates*

4.48 As part of its work on behalf of TalkTalk, Plum has estimated the indirect gains to BT– including gains to BT Retail– resulting from the proposed deal with DCMS. Irrespective of whether LR-VDSL proves usable or not, Plum estimates total indirect benefits to BT of £67m from undertaking work to improve all broadband speeds to a minimum of 10 Mbps under its proposal. This is considerably greater than Ofcom's estimate of £1m-4m per annum, and would have an appreciable impact on the bills faced by Sky, TalkTalk, and their customers.

4.49 This discrepancy provides a further reason for Ofcom to make greater efforts to calculate the benefits accrued by BT Retail, and to take these into account. On the basis of Plum's analysis, the regulatory failure caused by not taking the indirect benefits to BT Retail into account is substantial, and is of the scale that should provide a strong rationale for making efforts to amend this failure.

4.8 Ofcom does not appear model LR-VDSL appropriately

4.50 Ofcom discusses LR-VDSL at various points throughout its consultation, but notes at §5.25 that in its base case it assumes that BT does not use LR-VDSL in rolling out 10 Mbps broadband nationally. At Annex 8 it models the use of LR-VDSL as a sensitivity, but confusingly finds that costs would be around 20% **higher** in 2020/21 if LR-VDSL works (rather than proves unsuccessful, as in the base case).

4.51 There are two primary reasons to think that this modelling is flawed:

- *it conflicts starkly with the results of Plum's analysis*– the most important sensitivity in Plum's analysis on behalf of TalkTalk is whether LR-VDSL proves effective or not. Plum estimates that the total cost of provision (under a coverage deal between BT and Government) is reduced by more than 50% – £276m – in the event that LR-VDSL proves effective. This compares with a 20% increase in Cartesian's modelling on behalf of Ofcom. Such a large discrepancy is troubling, and implies that there are significant errors in one or both of Cartesian and Plum's models of LR-VDSL.
- *it is counterintuitive that LR-VDSL would increase costs*– if LR-VDSL were a technology that was expected to prove more expensive than using a mix of FTTC and FTTP, it is unlikely that BT would be continuing to invest in its development. There would be no point in doing so– it is superfluous to develop technologies which are more expensive than those which it is

hoped they supplant, and which will have shorter asset lives, meaning that they need to be replaced more quickly.[20] BT's continuing development of LR-VDSL is likely to be dependent on it reducing, rather than increasing, the costs of serving customers located far from their exchange.

4.52 Given these considerations, it is unlikely that LR-VDSL is in fact higher cost per customer than an FTTC/P mix in the absence of LR-VDSL. Ofcom should therefore revisit its assessment, and in particular the assumed asset lives of LR-VDSL assets, which appear to be one of the main drivers of the counterintuitive result.

4.9 The approach breaches accepted approaches to cost allocation

4.53 Ofcom discusses its approach to allocating the cost of the proposed agreement between DCMS and BT at §§6.13-6.22 of its consultation paper. In essence, its argument is as follows:

- Ofcom do '*not want the allocation of the costs associated with network expansion to distort the absolute pricing differential set out in the March 2017 WLA consultation*'. Ofcom states that allocating all the costs to FTTC lines would not do this, as it would by its nature expand the gap between MPF only and MPF + FTTC lines. Ofcom rejects an equi-proportionate mark-up (EPMU) approach for the same reason.
- '*Neither the allocation of costs to all lines not the allocation of costs to all broadband lines is consistent with cost causation as these costs are caused by the additional network deployment*'. Ofcom then goes on to make comments consistent with Ramsey pricing not offering a clear preference for all broadband lines relative to all lines.
- Ofcom then notes that the cost causation principle points towards recovery over all lines, without rationalising or supporting this statement.
- It is then asserted that the distribution of benefits principle points towards recovery over all broadband lines, as '*some may benefit directly from the network expansion*' and '*some third parties may also indirectly benefit*'. In contrast, it is then noted that '*indirect benefits such as greater social inclusion and greater access to learning opportunities are potential positive externalities that would benefit the whole of society*' pointing towards all lines rather than all broadband lines.
- Finally, Ofcom notes that if LR-VDSL works (which is not included in Ofcom's base case) then customers at these cabinets may benefit, and existing fibre customers served by these cabinets may see an improvement in performance. It may also lead to further take-up of SFBB by SBB customers.

4.54 As a result of all these various indicia, Ofcom decides to propose that costs are recovered from all broadband lines, '*because a significant number of broadband*

[20] See §A8.26 of Ofcom's consultation regarding asset lives.

customers could benefit from the additional network deployment and the difference in the mark-up between the all lines option and the all broadband lines option is small.'

4.9.1 *Analysis of Ofcom's argument*

4.55 In summary, Ofcom's argument at §§6.13-6.22 lacks evidential support, is incoherent, and is contradicted by proper use of evidence and scrutiny. Every element of its argument is, to a greater or lesser extent, flawed:

- Ofcom does not rationalise why it was appropriate in the main WLA consultation to allocate costs between MPF and GEA based on an EPMU approach, but it is inappropriate to allocate the costs of network expansion using the same EPMU approach. This is inconsistent and contradictory.
- Ofcom rules out the all fibre lines option at §6.14 without giving it further analysis, and therefore does not assess it against the same criteria that it considers for the all lines and the all broadband lines options, despite it leading to better outcomes in terms of cost causation (the costs of network expansion are costs of extending FTTC/P roll-out) and distribution of benefits (the benefits from network expansion only go to customers who choose to take an FTTC/P product in Ofcom's base case where LR-VDSL is not used). A 'preference' for one option should not rule out a full assessment of that option, and this appears to be a case of Ofcom being prejudiced when conducting its assessment.
- Ofcom rules out the Ramsey pricing approach at §6.15 without presenting any evidence that fixed line and broadband customers now have similar elasticities of demand. As this diverges from Ofcom's previous approach in this regard it is particularly important for Ofcom to present a fully evidenced view of what has altered.
- Ofcom presents no evidence that broadband customers who do not take an FTTC/P product as an overlay will benefit from network expansion. In the base case where LR-VDSL is not used, they will experience no benefits from the network expansion. In effect, in this regard there is no difference between the all lines and all broadband lines options, when both are considered with respect to the all fibre lines option. It is the customers taking FTTC/P lines who will benefit; whether customers take copper-based broadband or voice only, they will not benefit from the network expansion. This is particularly important given that TalkTalk expects that there are almost no MPF-based customers who will be in areas covered by the proposed agreement between DCMS and BT: most of these customers will be in rural exchanges which have not been unbundled by TalkTalk, Sky or Vodafone. As such, MPF customers <u>cannot</u> benefit from the proposed agreement; they will have no choice to move to improved services. §6.20 is therefore a hypothetical, as there will be few if any MPF customers who

are able to trade up to superfast broadband services following network expansion.

- Ofcom's comment that '*some third parties may also indirectly benefit*' (§6.17) is unclear, unevidenced, and counterintuitive. No potential methods by which these unidentified third parties would benefit are cited, and there appears to be no *a priori* reason why they would do so.
- [✂].

4.56 Ofcom should therefore revisit its approach. Its current proposals are close to the worst possible option, lacking evidential support, affecting TalkTalk voice only customers, and allocating costs to MPF customers who cannot benefit from the proposals. Ofcom should therefore revisit its approach to allocating costs.

4.10 Ofcom has no proposals preventing BT from failing to invest after reaching an agreement with DCMS

4.57 When Ofcom refers to the proposed agreement between DCMS and BT, it states that it will allow BT to receive an uplift in its price caps for MPF and GEA where there has been a '*clear and public agreement between BT and Government*'. It then proceeds to estimate the uplift in charge caps which is proposed to be given to BT to reflect this '*clear and public*' agreement.

4.58 It is notable– and important– that Ofcom does not say that the agreement needs to be legally binding on BT in order to grant BT an uplift in price caps. It is very unclear what a 'clear and public agreement' would be– in principle, it would seem that it could be as little as a joint press release between DCMS and BT. There appears to be no obvious minimum level of certainty that BT will actually invest which Ofcom will require before uplifting its charge caps.

4.59 This is inappropriate. Ofcom should only take an 'agreement' into account if it is a formal, legally binding, agreement, with the potential for penalties on BT in the case that investment does not proceed as expected. In the absence of such an unambiguous and legally binding agreement, then Ofcom cannot have a reasonable expectation that BT will invest in network expansion with any degree of certainty, and should not take the costs of an agreement that is not certain to lead to improved broadband into account when setting price caps. It is notable that DCMS, in its press release, states that any agreement will be legally binding, but that Ofcom does not impose this as a condition of taking the agreement into account when setting prices.

4.60 If Ofcom wished to proceed under the basis of the agreement being '*clear and public*'– which it should not– then it should set out transparent assessment criteria by which it will determine whether the agreement has sufficient clarity and publicity in order to be sufficient to increase price caps by the significant amounts proposed by Ofcom in its consultation. It has not done so, and this provides further support to TalkTalk's argument that Ofcom should only accept a legally binding agreement between DCMS and BT as being sufficient.

4.61 The problem is particularly acute because Ofcom does not propose any clawback or price cap reductions in the case that speed upgrades to over 10 Mbps proceed more slowly than currently expected. This is particularly important given the history of BT rural rollout programmes being delayed. For instance, the National Audit Office criticised the BDUK programme for running nearly two years behind schedule – it concluded: "*The Department currently estimates that the Programme will reach its target 22 months later than initially planned*"[21].

4.62 As Ofcom notes at §1.5 of its consultation, the current rumoured proposal is that BT will have completed its roll-out in areas subject to the agreement by the end of 2020. However, in the event that BT delays this roll-out– for example, so that it is completed by the end of 2022– under Ofcom's proposals TalkTalk and other CPs have no recourse, and will continue to pay increased charges for 'improvements' which may not yet even have started to be rolled out.

4.63 It is inappropriate for Ofcom to combine acceptance of an agreement which may not have any legal standing or force, with a lack of remedies for delay or cancellation of the project. Ofcom's current proposals risk BT being given tens of millions of pounds of excess profits over the next charge control period, without Ofcom having any immediate way of preventing this from occurring. This is an unacceptable risk to take.

4.64 Furthermore, there is no obvious reason why Ofcom could not set up a mechanism which reduces payments to BT in the event that it does not meet its target of achieving 100% coverage of 10Mbps broadband by the end of 2020. Although this would not prevent over-recovery in 2018/19 and 2019/20, it would do so in 2020/21, which is the single year with over of half the payments for network expansion over the forthcoming charge control.

4.65 Ofcom should therefore:

- not take into account when setting price caps any agreement between DCMS and BT unless it is legally binding in nature, and fully signed at the time when Ofcom makes its decision, without any meaningful aspects still to be agreed or determined;
- put in place a clawback mechanism which would have the effect of reducing revenues to BT in the event that it postpones or cancels the rollout of 10 Mbps broadband to all parts of the country.

4.11 Ofcom has not taken potential BDUK clawback payments into account

4.66 On 9 September 2017 DCMS issued a public statement on the progress of the BDUK scheme for subsidising rural broadband roll-out.[22] In it, Minister of State for Digital, Matt Hancock, stated that:

[21] NAO Report: The rural broadband programme July 2013

[22] https://www.gov.uk/government/news/the-great-british-broadband-boost

take-up has been higher than expected and as a result the major supplier, BT, has set aside £465m to extend coverage over the full lifetime of the contracts… Combined with project efficiencies of £180m resulting from successful management and delivery of the programme, there will be up to £645m available for local authorities to re-invest and take superfast speeds to those homes and businesses not already covered by existing plans. Of this, over £200m has already been committed to projects to extend superfast broadband.

4.67 On the basis of this quote, it appears that in the region of £440m will be available for further rural broadband improvements from BDUK funding in the near future, and certainly before the end of 2020. There also appears to be the prospect that there might be further rounds of BDUK clawback payments to come– the clawback payments have increased by over £170m in less than a year according to DCMS, which would tend to imply that they may yet increase further as take-up of SFBB increases.

4.68 It is notable that the £440m is the vast majority of the £546m that Ofcom estimates that the proportion of the roll-out dealt with via fixed access would cost, and is approximately the same as the gross costs which Plum estimates for this roll-out.

4.69 Furthermore, following the logic of BDUK roll-out to date (that funds are invested in areas with the lowest cost to serve each customer first, with gradually more expensive areas being covered through clawback payments from earlier, lower cost, areas) the areas which BDUK funds will be devoted to are precisely the areas which Ofcom is proposing to fund through the uplift to WLA price caps. When considering how much to provide BT in additional funding to cover roll out of universal 10 Mbps broadband, Ofcom should therefore take BDUK clawback payments into account, and net them off any funding provided to BT.

4.70 Once around £440m is netted off the required funding for BT, along with the indirect benefits to BT (which Ofcom estimates at £1m-£4m per annum, and Plum estimates at £67m over the project lifetime), the overall cost to BT will be low– less than £100m for the entire project, even if indirect benefits are at minimal levels and there is no further clawback. In this case, Ofcom should consider whether, given the prospects of further clawback, it would be appropriate to include any uplift to BT at all for network expansion within the current charge control, or whether any excess project costs should be backloaded into the charge control starting in 2021, by which time it will be clearer whether there will be additional BDUK clawback, whether LR-VDSL is an effective technology, and what the true costs of network expansion will be.

5 Conclusion

5.1 Ofcom’s proposals on funding the costs of network expansion are legally and economically wrong:

- Ofcom is wrong not to have conducted a full legal analysis of the proposed agreement between DCMS and BT. Had it done so, it would both have produced a clearer consultation, better meeting Ofcom's public law obligation to provide proposals with sufficient clarity to allow proper consultation, and potentially avoiding some of the other problems which affect Ofcom's consultation.
- Ofcom is wrong not to have taken the Universal Service Directive into account, as the USD clearly applies in this case. Ofcom cannot escape the USD by renaming a universal service obligation as something else. The underlying features of the 'network expansion' are the same as those of a USO, and so the same legal obligations apply.
- Ofcom should have set out its reasoning for why it would accept the outcome of any potential agreement between DCMS and BT, and opened that up to consultation, rather than prejudging, in the absence of consultation, that it would adjust price caps up to reflect any agreement.
- Ofcom should have given greater weight to the distortion of competition between Virgin Media and operators based on the Openreach network that occurs due to the proposed method of funding network expansion. In its current consultation, no analysis at all is presented of this distortion, which is central to the relevant costs and benefits of the proposed agreement between DCMS and BT.
- Ofcom has not reflected the potential for BDUK to finance a large proportion of the proposed network expansion through funds recycled from clawback payments. This means that BT is likely to over-recover, being paid for network expansion both directly from BDUK funding, and also through increased WLA price caps.
- Ofcom can have no certainty that increased price caps will lead to network expansion actually taking place, or take place at the speed currently envisaged, as it is not insisting upon any legally binding obligations being imposed on BT prior to providing funding for network expansion. This creates a serious risk that BT may over-recover in the next charge control period for the costs of network expansion.

5.2 These issues are fundamental to Ofcom's consultation. Ofcom should address them in full, and consult on how they have been addressed, before finalising its proposed approach to dealing with the potential agreement between DCMS and BT.