



# Wholesale Local Access Market Review

Further consultations on:

Proposed charge control for wholesale standard  
and superfast broadband

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Quality of Service for WLR, MPF and GEA

Vodafone Response

October 2017



## Executive Summary

This is Vodafone's third submission to Ofcom's wholesale local access market review<sup>1</sup>. This paper responds to Ofcom's two further consultations; one relating to Ofcom's proposed reduced quality of service requirements for the Wholesale Local Access Markets<sup>2</sup> and one in relation to increasing proposed GEA prices due to cost modelling changes<sup>3</sup>.

Vodafone responded to Ofcom's initial wholesale local access market review<sup>4</sup> and we also responded to Ofcom's consultation regarding proposed increases to GEA and MPF prices to allow BT further investment funds for roll-out of copper based 10Mbit/s broadband services in rural areas<sup>5</sup>

The net impact of these further two consultations is for Ofcom to propose to increase the modelled 'allowable' costs in the WLA cost stack and thus increase the proposed prices Openreach can charge for MPF and GEA products, whilst at the same time lowering the service levels Openreach will be expected to deliver. The fundamental issue with both Openreach's level of costs and the service level they provide is their historic under-investment in their WLA network, something that Openreach themselves have publicly acknowledged<sup>6</sup>. This has left Openreach running a legacy copper network that is struggling to meet the demands of consumers, with ageing infrastructure being pushed hard to deliver ever higher broadband speeds, something it was never designed to support. Perhaps the most disappointing aspect of this situation is that BT has had the ability to invest throughout the last market review periods, with Ofcom's modelling approach specifically allowing BT to make a return as though they were investing in their network (i.e. Ofcom's hypothetical ongoing network approach).

However, instead we find we are carrying out another Market Review, without ambition or expectation:

- BT have maximised the asymmetric information advantage they have and provided Ofcom with selected additional information with the purpose of convincing Ofcom to increase the modelled cost base. Ofcom should not base these proposal revisions on one sided bias information.
- Ofcom's initial quality of service proposals offered a reasonable trade-off between a progression to improved repair service standards for all customers (using Openreach care SML1 and SML2) and the costs of achieving the higher standards, it is disappointing that Ofcom have been so easily persuaded to compromise on them.
- These revised quality of service proposals are unacceptable and would mean that the average consumer using Openreach care SML1 would contribute far more to the cost of quality while seeing no quality improvement at all over the period. We propose that Ofcom address these flaws in the proposal by setting care level specific minimum service standards for each of the Openreach care levels in order to reduce the opportunity for regulatory gaming and that Ofcom stands firm in implementing suitably tough minimum standards.

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<sup>1</sup> <https://www.ofcom.org.uk/consultations-and-statements/category-1/wholesale-local-access-market-review>

<sup>2</sup> [https://www.ofcom.org.uk/consultations-and-statements/category-2/quality-service-wlr-mpf-gea?SQ\\_VARIATION\\_106296=0](https://www.ofcom.org.uk/consultations-and-statements/category-2/quality-service-wlr-mpf-gea?SQ_VARIATION_106296=0)

<sup>3</sup> <https://www.ofcom.org.uk/consultations-and-statements/category-2/wla-market-review-further-consultation-on-charge-control>

<sup>4</sup> [https://www.ofcom.org.uk/data/assets/pdf\\_file/0017/105029/Vodafone.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0017/105029/Vodafone.pdf)

<sup>5</sup> [https://www.ofcom.org.uk/data/assets/pdf\\_file/0021/107049/Vodafone.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0021/107049/Vodafone.pdf)

<sup>6</sup> <http://www.telegraph.co.uk/business/2017/02/01/openreach-chairman-says-bt-should-have-invested-better-broadband>



- Ofcom have not proposed any safeguards against BT over-recovering one of its largest, and most difficult to forecast costs, cumulo costs, and instead BT has the opportunity and scope to make a healthy profit on the cumulo costs they pass on to customers by appealing against the recent business rate decision.



# 1. Proposed charge control for wholesale standard and superfast broadband

## 1.1 Introduction

In June this year we responded<sup>7</sup> to Ofcom's WLA market review consultation. In that response we set out that regardless of the eventual size and scope of the charge control, it is important that the assumptions used in establishing pricing trajectories are based on robust cost information.

We also set out our view that a *soft* charge control based on weak or inaccurate assumptions, or one that gives the benefit of the doubt to BT across a series of cumulative calculations will not serve the consumer interest and will lead to meritless over-recovery by Openreach and will result in consumers paying higher prices. Vodafone considers that this latest consultation, focused on opening up cost categories where Openreach has spotted opportunities for changing parameters in order to increase the eventual charge controlled prices, does just that. BT has, by using their key advantage of information asymmetry been able to influence Ofcom, and now Ofcom is proposing to increase the price of GEA services in 2020/21 by nearly £2 and lower the service level targets of both MPF and GEA services, compared with their March 2017 proposals.

Ofcom's fundamental approach to modelling costs of MPF/WLR services sets out a capex forecast, assuming an ongoing network with a steady state adjustment with associated increases in the value of heavily depreciated assets. This modelling approach gifts BT returns far in excess of their **actual** cost of capital employed and the baseline cost model will always over recovery actual costs. Therefore, any additional assumptions, considerations or concerns Ofcom might have in BT's ability to recover costs needs to be assessed with this fundamental position in mind. This is why Vodafone considers that Ofcom have:

- been far too conservative in its assessment of BT's ability to reduce its Cumulo costs;
- dis-incentivised BT from investing by rewarding them with additional recovery of costs that will be incurred because BT have not, in the past invested;
- dis-incentivised BT from investing by allowing them to deliver lower quality of service levels (than Ofcom originally demanded) because of additional operating costs that are incurred by their legacy older assets to meet higher service levels;

In this section we set out Vodafone's views on Ofcom's proposals and Vodafone's further views on Ofcom's response to our initial response to the WLA consultation in July 2017:

In section 1.2 we explain the inherent issue with information asymmetry;

In sections 1.3 and 1.4 we explain our view on how Ofcom have reduced the quality of service expected of Openreach whilst increasing the allowable costs;

In section 1.5 we set out our view of the proposed SLG payment forecast;

In section 1.6 and 1.7 we explain our view of Ofcom's revised forecast of modelling parameters;

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<sup>7</sup> [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0010/105121/Vodafone.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0010/105121/Vodafone.pdf)



In section 1.8 we respond to Ofcom's proposal for the pricing of ancillary services and in particular GEA Cancel/Amend/modify services.

## 1.2 Overcoming information asymmetry in regulatory decision making

Before we comment on the detail of Ofcom's proposed amendments to its April 2017 proposals, we thought it would be useful to pause and reflect on the process of establishing those proposals. Ofcom issued various s.135 information requests during 2016 and 2017, a fibre cost model was published in 2016 and then finally Ofcom published its own calculation on proposed regulations in March 2017. We can only assume that as a key stakeholder BT would have also been involved in many more direct engagements during that time period. However it is only after Ofcom publishes its proposed charge control in March 2017, that BT then finds new data to increase the value of certain cost elements.<sup>8</sup> This additional step in the process is weighted in BT's favour. Ofcom and other stakeholders are at a disadvantage:

- In regulating the price of SMP services offered by BT (where market failure exists), Ofcom face a significant information constraint, with BT having much better knowledge of its own numbers than Ofcom and other stakeholders, this gives rise to a strong information asymmetry that can compromise the fairness of charge control outcomes unless adjustments are made to take account for it.
- While Ofcom can use formal powers to require BT to provide information, there will always be limits to the completeness of information supplied. This is also true when such information is volunteered by BT, as it is likely to support BT's own advocacy, rather than giving a balanced picture.
- With no clawback for outperformance of the controls, there is no incentive for BT not to behave in this way and there are no penalties applied to BT for not revealing full information if such information is volunteered.

BT is a well-resourced organisation, and with charge controls worth many millions of pounds, it is no wonder it has a very strong commercial incentive to behave in this way. In contrast Ofcom faces difficult resourcing issues when running a number of projects and is often under time pressure to complete charge controls and market reviews. This combination can give rise to the unintended consequence of regulatory capture where BT helps Ofcom by providing information and models to set the charge control. Any bias in the results cannot be spotted by Ofcom and their cumulative materiality to BT can be under estimated.

This late data exchange by BT in this WLA Market Review and charge control consultation process reflects the lack of up front information exchange earlier in the process, resulting in BT being able to push back on Ofcom's final proposals, with a stronger information hand.

## 1.3 Taking account of our proposed quality of service changes

### 1.3.1 Fault volume reductions

In March Ofcom consulted on BT's fault volume reduction programme and calculated that this could reduce unit costs for MPF services by £2.21. Ofcom also explained that the costs of BT's fault reduction programme were recovered in Ofcom's modelling approach whereby the additional investment capital and assets (mean capital employed) were uplifted to reflect that of a steady state on-going network. This meant that no further costs were required to be added to Ofcom's charge control model because doing so would have enabled BT

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<sup>8</sup> You will note that all of BT's proposals increase the charge control in its favour. According to BT, Ofcom makes no error that would reduce the controlled charges.



to double recover their fault volume reduction programme costs This is shown in a redacted figure in Ofcom's latest consultation.<sup>9</sup> It appears from Ofcom's associated text, that BT's costs of providing this fault reduction programme were more than covered by the modelled uplift to capital expenditure.

However, BT has now provided information to Ofcom that indicates a possible 35% of the costs of this programme could be operating expenditure and not capital expenditure. As a result, Ofcom is now proposing to increase the modelled operating costs **but not reduce the modelled capital expenditure**. Vodafone considers this a clear case of double recovery; correcting one element of the model and not counter-correcting is fundamentally wrong. The risk of gaming by classifying costs as either operating costs or capital costs has long been recognised by regulators and is why Ofgem and Ofwat focus more on a "totex" approach.

Under Ofcom's current proposal more than 100% of the costs of BT's fault volume reduction programme will be recovered through the allowed capital expenditure envelope in the charge control and a further 35% of the costs will be additionally recovered through operating cost uplift. Vodafone considers that BT should only be able to recover 100% of their costs regardless of how they classify them; and therefore Ofcom needs to reduce the capital expenditure allowance if it is to proceed with this proposal to allow additional operating costs in the charge control. This error must be corrected such that, instead of a proposed £1.59 reduction to unit MPF costs Ofcom should revert to their original estimate of £2.21 and ensure BT does not double recover their costs.

#### 1.4 Resource uplift to meet higher repair standard

BT has provided further evidence to Ofcom relating to the costs and feasibility of Ofcom's proposed quality of service standards and costs; this is discussed further in section 2. Ofcom proposes that the net quality of service standards should not be 90% delivery to the metric expected in 2020/21, but a net 85% is now being expected in 2020/21. Associated with these reduced standards are *increases* in the unit costs (compared to those costs that Ofcom predicted were necessary to meet the 90% standard). And yet we find that BT already meets some of these standards in some locations, suggesting no further investment is necessary. Ofcom state that this will increase prices by £0.83 and £0.60 for MPF and GEA services respectively.

Vodafone understands that the basis for Ofcom's reduction of BT's expected quality standards and increased costs is the new evidence that Openreach has provided on the feasibility of different levels of service that it can provide, and Openreach's model that estimate the costs of providing service levels. There is insufficient transparency of information to comment on the details of this adjustment, however Vodafone would like to point out that rewarding BT with additional costs and lowering the quality of service expectations placed upon them *disincentives them from investing*. If indeed BT were to be challenged on the quality they are expected to provide, and not allowed to recover costs occurring due to higher ongoing maintenance costs arising due to the continued use of older legacy assets then BT would be incentivised to invest in newer fibre based services.

#### 1.5 SLG payment forecast

Vodafone considers that the additional costs Ofcom have added (approximately £30million) to the charge controlled cost stack that BT is allowed to recover is a very good example of how BT has used the power of information asymmetry to influence a better outcome for itself. BT do not appear to have provided any

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<sup>9</sup> Figure 3.8, [https://www.ofcom.org.uk/data/assets/pdf\\_file/0023/106448/Proposed-charge-control-for-wholesale-standard-and-superfast-broadband.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0023/106448/Proposed-charge-control-for-wholesale-standard-and-superfast-broadband.pdf)



evidence to support the reduction of any allowable costs, indeed they do not need to and it would be commercially very unwise for them to do so.

Although economically sound, the method of allowing BT to recover costs that they incur due to their inability to provide the service they are contracted to provide is rather unpalatable and should be highly scrutinised by Ofcom. This approach does not take account of the incremental costs that Vodafone (and other customers, and downstream users) face as a result of BT's failure to deliver. We have no mechanism to recover these costs and yet we face funding BT's additional costs.

To the extent that Vodafone can assess the new level of costs added from the information provided it would appear that the suggestion from BT that they might incur additional costs associated with SLG's in the future is highly subjective and speculative. Ofcom should base their modelled base year costs on BT's actual costs incurred, rather than BT's projections, and to the extent that Ofcom do base modelled costs on BT's projections, Ofcom should through disclosure in the regulated accounts require BT to report actual costs.

## **1.6 LRIC to FAC ratios**

Vodafone understands that Ofcom has changed the approach to using LRIC to FAC ratios to forecast costs in that (1) OCM depreciation and holding gain categories are now considered, and (2) the weighting of the LRIC to FAC ratios are now based on each year and not simply the 2015/16 level.

Due to the lack of disclosure and the audit state of the LRIC model, Vodafone cannot comment on the appropriateness of these changes, however we would like to reiterate that the unaudited, opaque, BT LRIC model has a significant impact on actual wholesale prices.

These relatively small changes to the way the LRIC model results are used and implemented change the MPF and GEA prices by £1.40 and £0.40 respectively and although this unit amount are not individually significant, considering the volume of the services consumed the total absolute amounts for BT are very significant. Vodafone considered that a comprehensive review of the LRIC model, similar to that which the RFS was subject to back in 2015 is long overdue.<sup>10</sup>

## **1.7 Cumulo non-domestic rates**

As Ofcom explain in their consultation cumulo business rates are the 'property tax' type rates BT pay on all of its rateable assets in the UK, the term Cumulo refers to the value being calculated on BT's assets as a whole. Thus the challenge for Ofcom is to attribute these rates to the individual assets and ultimately the services that BT provides. As Ofcom discussed in their March consultation these rates are set to rise significantly over the next few years. Ofcom suggested<sup>11</sup> these rates could increase for BT as a whole by over 300% to just over £800million.

This makes cumulo business rates probably one of the single most significant individual costs to BT Group, and one of the highest costs BT wish to recover from regulated services. In addition to this, because of the drastic increase in rates and the avenues open to BT to appeal this increase in rates, the actual value BT will pay is subject to a high degree of uncertainty.

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<sup>10</sup> <https://www.ofcom.org.uk/consultations-and-statements/category-2/cost-attribution-review>

<sup>11</sup> Table A17.3 [https://www.ofcom.org.uk/data/assets/pdf\\_file/0035/99638/Annexes1-19.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0035/99638/Annexes1-19.pdf)



This is why we, in our response in June 2017 to the WLA consultation called on Ofcom to:

- Set up a pass-through mechanism that enabled BT to only recover the cumulo business rates that it actually incurred
- Require BT to publish a full reconciliation of how business rates are attributed to the different products and services to enable stakeholders to assess whether BT was recovering a fair portion of rates from regulated services, and
- At least take into account the fact that BT will appeal the business rate decision and will end up paying lower actual rates than is currently forecast.

We also, in our response in June sought to assess at a high level whether, at the overall BT Group level business rates were equitably allocated across products and markets using revenue as a rough proxy.

We deal with Ofcom's new additional proposals and comments on our response in June below.

### **1.7.1 Cumulo pass through mechanism**

Vodafone welcomes Ofcom's consideration of introducing this mechanism and would like to reiterate that the main driver for suggesting such a mechanism is due to the significant increase and changes in the rates BT pay. As discussed previously, there has been a step change in the value of business rates that BT will be subject to and this requires Ofcom to fundamentally reassess its approach. Ofcom's main argument for not currently proposing a pass-through mechanism appears to be:<sup>12</sup>

*"The writing of any relevant legal conditions to cover all such possibilities, whilst not impossible, would not be straightforward and Ofcom has not previously imposed such conditions."*

Vodafone suggests that just because it is difficult and Ofcom have not previously done it, does not constitute a valid reason for now not considering it. We also consider that the statement below from Ofcom is incorrect:<sup>13</sup>

*These would introduce further complexity with a greater risk that doing so might not achieve the objective of reflecting future RV reductions within the charge control period.*

Although when practically implemented a pass through mechanism will probably not 100% guarantee BT only recover their actual incurred Cumulo costs due to timing and mechanistic imperfections, a pass through system that considers the rates BT actually pays will always provide an improved, more accurate (i.e. BT's recovered rates are closer to their incurred rates) recovery of costs.

### **1.7.2 Ofcom's forecasting of BT's cumulo costs**

We welcome Ofcom acknowledgement that not anticipating BT will appeal and be able to reduce their business rates would lead to windfall gains for BT.

Ofcom's approach to forecasting 3-year glide path charge controls and incentivising BT to beat their efficiency targets to reduce costs, drives the right economic incentives for BT and Vodafone generally agrees with this overall approach. However, Vodafone does not consider that cumulo costs should be considered in this overall

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<sup>12</sup> Paragraph 3.39 [https://www.ofcom.org.uk/data/assets/pdf\\_file/0023/106448/Proposed-charge-control-for-wholesale-standard-and-superfast-broadband.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0023/106448/Proposed-charge-control-for-wholesale-standard-and-superfast-broadband.pdf)

<sup>13</sup> Paragraph 3.39 [https://www.ofcom.org.uk/data/assets/pdf\\_file/0023/106448/Proposed-charge-control-for-wholesale-standard-and-superfast-broadband.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0023/106448/Proposed-charge-control-for-wholesale-standard-and-superfast-broadband.pdf)





approach, a significant portion of BT's Cumulo costs should not be recovered from regulatory services and therefore BT is already incentivised to reduce their overall business rates.

Under Ofcom's current approach BT's main avenue for beating the charge control cost forecast and becoming more cost efficient is by reducing their business rates bill. This is not the cost area of the charge control BT should be focusing on, and simply including business rates in the 'usual' cost forecast risks driving mis-guided cost efficiency incentives.

We understand that Ofcom are now proposing to forecast that BT will be able to achieve a 25% reduction in their 1 April 2017 rateable values and that this, due to other changes reflects a 9% reduction in the business rates compared to the March 2017 consultation. Vodafone have considered the evidence that Ofcom have reviewed to reach its current proposal; Virgin media's and KCOM's rateable value, the ratios, the reduction, the lightly hood of BT appealing and scale of the reduction they may achieve. Vodafone is very sympathetic to the complexity of the forecasting task and considers that it is very difficult to forecast the rates with any degree of certainty. However Vodafone considers that the risks of BT over-recovering are far higher than the risks of BT under-recovering their costs, this is because of the backdrop of £10.5bn in excess profits over the last 12 years.<sup>14</sup>

In terms of the attribution of BT's cumulo services to products and markets it is difficult to engage in the data in a meaningful way because (1) of the limited information disclosed, and (2) it is not clear to Vodafone precisely how Ofcom allocate BT's cumulo costs to services. In our June 2017 response we attempted to present a high level picture and compared cumulo allocations to revenues by market. The purpose of presenting this picture was to introduce Ofcom to the idea that stakeholders have an increased desire (now business rate costs have increased) to have transparency and a high level view of how Cumulo costs are attributed to services. Vodafone accepts Ofcom's comments that revenue is not a very good proxy for the attribution of Cumulo costs and that possibly duct usage is a better proxy. However, Vodafone is disappointed that Ofcom did not attempt to present a similar analysis and show stakeholders in a more meaningful transparent way how Cumulo costs are attributed across products and markets.

## 1.8 GEA cancel/Amend/Modify and bandwidth modify

The fundamental reason these GEA ancillary charges occur is because of the highly prescriptive and 'active' tailored nature of the GEA product that BT delivers. Unlike MPF, where Vodafone could have carried out these activities themselves and incurred no, or a very small incremental cost, BT can increase the wholesale costs for other competing operators through these charges and make it difficult for them to offer a high value service to their customers.

Two examples of how this service is used to improve the quality of the service we offer to our customers are detailed below:

- **Quality of service:** customers have different specific requirements, even after they have selected a service, some customers require very high speeds and this is the attribute they value the most, whilst others would accept a slightly comprised speed to ensure continuous reliability. We use this product to make changes to our customer offerings so that our services more closely align with the customer needs. In doing so we incur these charges that we do not pass on to the customer and therefore to ensure a quality product we have to incur margin erosion through this charge.

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<sup>14</sup> [https://www.ofcom.org.uk/data/assets/pdf\\_file/0020/107048/Vodafone-Frontier-report.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0020/107048/Vodafone-Frontier-report.pdf)



- **Throughput management:** Although BT has reduced the price of GEA cable links, they have also informed wholesale stakeholders that there is limited exchange capacity and thus operators must be very efficient with their use of cablelinks and the number they request. Therefore, Vodafone and other operators will have to swap customers between links and ensure customers continue to receive a high quality service whilst making efficient use of cablelinks.

By charging excessively for these services, BT can limit a CP's ability to offer a high quality retail offering, and therefore Vodafone believes these services should be priced at their incremental cost only. Unfortunately, BT and Ofcom do not know the LRIC, or indeed the FAC costs of providing these services.

BT was able to offer these services in the form of bunk migrations for 20p per migration; however, BT has now increased the charges for bulk migrations to a level where they are currently priced higher than single migrations. In view of the fact that BT has charged only 20p for these services, and that there is actually no physical alteration required and this simply requires a software change, Vodafone considers that 20p should cover BT's incurred costs, unless BT can prove that the incurred costs are higher. Openreach's charges should be based on actual costs incurred and not their commercial strategy, and using the limited evidence available from what Openreach has actually charged, the prices currently proposed by Ofcom seem far higher than BT's actual costs incurred.

Vodafone have submitted this as a SoR to Openreach over the summer, however Openreach have responded by saying that this is being reviewed by Ofcom and is part of the market review process. We would look to Ofcom to ensure such charges are based on cost and reflect the scale of the intervention required, which in this case is modest and amounts to pennies rather than pounds.



## 2. Quality of Service for WLR, MPF and GEA

### 2.1 Introduction

In regulated markets where BT is subject to remedies imposed by Ofcom designed to protect the consumer from the extremes of market failure, BT has a track record of making excess returns year after year from the sale of broadband, connectivity and telephony. In the last financial year alone (2016/17) BT made an excess profit from regulated services (on top of its weighted average cost of capital earnings) of £827M. In 2015/16 the excess amounted to £805M. In the 12 years since the creation of Openreach this excess has accumulated to a staggering £10.5Billion, and ultimately this is paid for by UK consumers.

Those excess profits should have been ploughed back into the network, improving the service experience and wholesale products offered by Openreach. However, the reality is that whilst excess profits have been earned, service experience has declined, with Ofcom intervention required to safeguard quality of service. BT chose profits over service and the lack of investment in both the network and service experience (for example by diverting earnings into FTTP investment or routine, scale proactive maintenance) has caused a service crisis that overshadows our industry today and the industry as a whole need to work hard to rebuild that trust.

Ofcom now consults<sup>15</sup> on changes to its March 2017 QoS proposals. As a result of this consultation we understand that Ofcom has established that BT has failed to invest the allocated capital permitted in the last charge control into capital projects in order to improve the fault rate and overall quality of copper services. BT has also failed to invest in FTTP which has a far lower fault rate and greatly improved service capability. In other countries FTTP rollout has overhauled service performance.

Despite this under-investment, BT is now requesting that Ofcom increase end consumers service charges so that end customers pay Openreach more money to allow excess earnings to continue, allowing BT to hire the necessary engineers to help get service levels back nearer to where they should be, whilst not harming BT shareholders who have become accustomed to benefiting from the excessive returns earned in regulated markets.

Ofcom's initial proposals offered a reasonable trade between a progression to improved repair service standards for all customers (using Openreach care SML1 and SML2) and the costs of achieving the higher standards. This second round of proposals is unacceptable and would mean that the average consumer (using Openreach care SML1) would contribute far more to the cost of quality while seeing no quality improvement at all over the period. In fact, these customers could actually experience a fall in the quality of service they receive today in some cases without any ramifications for BT (or its shareholders).

We propose that Ofcom address these flaws in the proposal by setting care level specific minimum service standards for each of the Openreach care levels in order to reduce the opportunity for regulatory gaming and that Ofcom stands firm in implementing suitably tough minimum standards. Openreach SML1 is a two day repair standard. In the normal course of events it is entirely possible that this type of repair can be conducted to time: currently this care level has experienced a positive trend that could take it to 90% and above. SML2

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<sup>15</sup> [https://www.ofcom.org.uk/data/assets/pdf\\_file/0012/106311/consultation-quality-service-wlr-mpf-gea.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0012/106311/consultation-quality-service-wlr-mpf-gea.pdf)



is a one day repair standard and consequently it is clear that the instances of failure are likely to impact the overall performance statistics, potentially requiring more investment to improve and starting from a lower base of performance today<sup>16</sup>. As they stand, Ofcom’s proposals provide no minimum service expectation of users of SML 2.5, 3 or 4.

We propose that Ofcom adopts the MSLs for each SML for repair as set out in the table below with the associated KPIs in order to achieve a regime that is objectively justifiable, not unduly discriminatory, proportionate and transparent: Our proposal also supports consumers of SML1 services by ensuring they retain higher service levels that they have experienced, and are consistent with expectations from Ofcom in regard to its proposals for Automatic Compensation. In its consultation on Automatic Compensation, Ofcom expresses a view that any reduction in service standards from today due to decreased MSLs will result in consumer harm. Our proposal additionally sets a MSL framework for all SMLs.

Openreach SML	Y1 Ofcom MSL	Y2 Ofcom MSL	Y3 Ofcom MSL
SML1 (two day repair)	83% (80%)	90% (87%)	93% (90%)
SML2 (one day repair)	83% (80%)	86% (83%)	88% (85%)

## 2.2 Putting Consumers ahead of shareholders

Vodafone continues to believe that there is no alternative than to take a joined up approach across policies intended to deliver service improvement: the proposals for Openreach’s minimum service level standards should work together, and support proposals for consumer automatic compensation.

Vodafone has responded to Ofcom’s first WLA QoS consultation<sup>17</sup> supporting the overall direction of the original proposals which sought to impose a steady improvement of the service floor for service provisioning and service repair across copper services across the UK. Those proposals would still have resulted in many customers having longer periods awaiting service repair and service provision compared to the SLA that BT offers with its products, but would still be a notable improvement for service expectations.

We note that separately Ofcom wishes to incentivise service improvement by Openreach via the proposals for consumer automatic compensation. The theory being that the additional costs of automatic compensation will motivate Openreach to improve service beyond the Ofcom MSL. This incentive is substantially lessened by the inclusion of such costs with the SLG costs recoverable from the charge control and individual service charges. We note that Ofcom has increased the SLG costs by approximately £30million and assumed this is to cover the costs of automatic compensation pass through. We consider that this is counterproductive and these costs should be removed.

In our initial response we highlighted the risk of MBORC allowances: in its response to the consultation BT has rather honestly identifies it wishes to use MBORC more widely to manage regional performance variations in

<sup>16</sup> Although of course users of this service already pay a higher rental charge and may question the value of their higher payment against the likelihood their service is repaired in the shortest time period.

<sup>17</sup> [https://www.ofcom.org.uk/data/assets/pdf\\_file/0010/105121/Vodafone.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0010/105121/Vodafone.pdf)



more circumstances than extreme weather situations<sup>18</sup>. It is not the intention of the regime to provide a get out of jail free pass for regions that have not employed sufficient engineers or not established the correct shift patterns. We consider a more nuanced approach is required whereby an allowance can be allowed but only invoked as incidents of MBORC actually occur and affect performance to the standards. For simplicity in responding to the current proposals, we replicate Ofcom's approach of showing the headline rate and the MBORC reduced rate.

### 2.3 Successive years of Excess Returns

Frontier Economics has undertaken a review of BT's profitability in regulated markets. The report<sup>19</sup> that Frontier has just undertaken considers whether the excess profits that BT earns translate into consumer benefit via greater investment in networks and services. The conclusion is that this has not been the case. Indeed, this consultation further demonstrates the accuracy of that conclusion, with excess profits earned by Openreach doing little to improve the wellbeing of end users. We see Openreach exhibits:

- an inability to perform beyond a certain ceiling;
- the necessity for an 11% increase in available resources to deliver better service which will have a service floor of just 85% across all services by 2020/21;
- a projected increased fault rate due to the primary network assets in some cases close to reaching 100 years in age and not being maintained.

The return on capital achieved for copper product markets (WLA and WBA) are enviable. The current regulatory situation enables BT to ignore the receipt of these super normal returns for SMP service markets and enter into each subsequent charge control and market review period with a renewed request for a new budget to improve service at the direct expense of end users as if the super normal profits did not occur.

The chart below illustrates the year on year excessive returns from the fixed access markets and broadband WBA markets. Last financial year 2016/1, on top of full cost recovery and a return on capital employed, an excess profit of £827M was made. In 2015/16 the excess amounted to £805M. In the 12 years of Openreach existence there has been a staggering £10.5Billion of excessive profits made from regulated services.

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<sup>18</sup> Openreach makes a number of concerning statements about the MBORC allowance in its response to the earlier consultation [https://www.ofcom.org.uk/data/assets/pdf\\_file/0013/105115/Openreach.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0013/105115/Openreach.pdf)

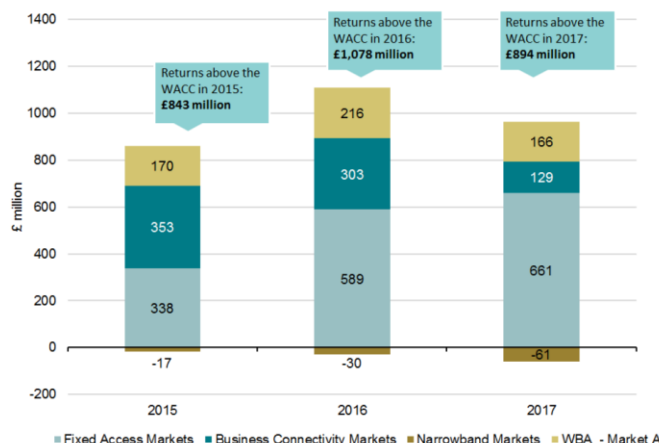
Para 176 proposes use of MBORC to deal with region performance variations rather than weather related performance issues - "*Even if we assumed that we could use High Level MBORC declarations to protect us from the worst of these local variations,*"

Para 13 requests change to the HL MBORC process to allow more qualifying events and an increase in the general allowance to 5%

<sup>19</sup> [https://www.ofcom.org.uk/data/assets/pdf\\_file/0020/107048/Vodafone-Frontier-report.pdf](https://www.ofcom.org.uk/data/assets/pdf_file/0020/107048/Vodafone-Frontier-report.pdf)



**Figure 3 Returns above the benchmark rate (WACC) for SMP Markets**



Source: Based on BT regulatory financial statements, Frontier analysis

We consider that appropriate regard needs to be given in the regulatory process of the past high returns which have been made at the expense of lower service improvements and lack of investment in the network, including a more timely transition to FTTP as the modern equivalent asset.

## 2.4 Performance analysis

Before we consider the proposals and evidence provided by Openreach in response to the initial consultation we look to the publically available evidence<sup>20</sup> on repair performance to obtain the latest outlook on performance. We look at the combined (the combination of performance for all the copper services offering that care level) position for each care level. This second consultation phase enables us to take into account the performance that has occurred since Ofcom will have reviewed performance to inform the March consultation proposals and to have a longer view of trends. It is not clear how Ofcom has developed the proposals for the present consultation regarding information on actual performance, as performance data is not discussed other than in the context of the Openreach evidence on glass ceilings which stops at the end of FY 2016/17.

### *Openreach SML1 (two day repair)*

The following chart identifies the performance achieved for Openreach SML1 (the two day repair) across each of the operating regions.

Regions (%)	Oct-Dec 16	Jan-Mar 17	Apr-Jun 17
Scotland	87.33	86.61	86.48
NI	90.66	91.38	91.95
North West	85.33	91.38	91.95
North East	81.02	85.39	85.01
North Wales/ North Mid	82.97	86.55	86.56
South Wales	79.49	86.57	89.23

<sup>20</sup> The data is taken from Regulatory KPI performance reporting on the Openreach website



East Anglia	80.63	84.57	87.49
Wessex	82.17	86.34	88.86
South East	84.47	85.29	88.65
London	85.1	90.08	88.8

Source: Openreach website

The table data shows that for SML 1 that:

Customers have experienced in all regions a progressive increase in the service levels observed between Oct/Dec 2016 and April/June 2017.

Service levels have been above the level Ofcom proposes to set the MSL at (85%) with even the worst performing region – the North East being at over 85% for the first half of the year.

Service levels for 6 of the 9 regions have been for the first half of the year around (slightly above/slightly below) the 90% service floor originally proposed.

In light of the statistics and the desire to bring service across the UK to a uniformly higher level, Ofcom's first consultation proposals are more relevant to SML1 than SML2.

UK customers will experience the cost increase within the product cost stack to improve quality of service for customers on SML2 (one day repair) while experiencing no service improvement themselves. Worse than this, these customers will not be guaranteed that their existing service levels will not drop back to the service floor in the event that Openreach uses the opportunity to cut costs, impacting service SML1 customers.

#### *Openreach SML2 (one day repair)*

The following chart identifies the performance achieved for Openreach SML2 (the one day repair) across each of the operating regions.

SML2 (%)	Oct-Dec 16	Jan-Mar 17	Apr-Jun 17
Scotland	78.71	78.3	80.33
NI	78.44	81.23	83.47
North West	80.96	83.18	83.78
North East	77.33	81.65	81.98
North Wales/ North Mid	78.84	81.47	81.41
South Wales	75.47	82.93	85.54
East Anglia	76.34	82.05	82.64
Wessex	76.49	81.96	84
South East	81.03	82.95	85.15
London	80.45	84.93	85.73

Source: Openreach website

It shows for SML2:



- A marked improvement between Oct-Dec 2016 and April June 2017 in delivery against target.
- The performance range in the final quarter is 80% to 85% across the regions. Three regions are already performing at the level Ofcom expects to see as a minimum in 3 years' time. There is no indication that there is a seasonality trend for performance to dip with improvement continuing on a steady trajectory.

## 2.5 Conclusion of findings

Undertaking this review demonstrates:

- Despite showing a marked improvement between Oct/Dec 2016 and April/June 2017 that there is a substantial difference in attainment from the start of period to the end of the period between SML1 and 2. This may well be by virtue of the likelihood that 2-day repair enables a greater range of repair activities, as cited by Openreach in the glass ceiling analysis, being completed.
- For SML1 the final quarter regional range is 85% to almost 92%. Here we can see that for SML2 the range in the final quarter is 80% to 85% across the regions.
- In light of the statistics and the desire to bring service across the UK to a uniformly high level Ofcom's second consultation proposals are more relevant to SML2 than SML1.

It is difficult to reconcile the data above with the information presented by Openreach on its glass ceiling review. We also note and question the exclusion of Northern Ireland from the statistics.





## 2.6 Consultation questions

### **Question 3.1: Do you agree with our revised position on Openreach's operational capabilities for on time repair? Please provide reasons and evidence in support of your views.**

In the first consultation Ofcom's view was that a glass ceiling of performance at 96.6% existed. Openreach has provided Ofcom new information which sets out that its operational limitations fall within a range between 88.7% - 90.8% increasing to 92.6% if CPs make certain changes. Openreach states it would not represent value for money to eliminate all service failures.

'Reject clear' can be used if a line test fails SIN349 yet is resolved via a non-appointed engineer process. The line test can be conducted at either the network end or in the premise. If the engineer cannot find a fault in the network, they will attempt to access the premise. If they cannot, the repair is returned to the CP in a '*clear reject*' state which requires the CP to book an appointment with the customer directly. It is reasonable that the repair clock is paused until an appointment is scheduled.

A proportion of repairs require the OR engineer to attend the premise despite this not been requested by Openreach at the outset of the fault report - "CP readiness none appointed". Vodafone and other CPs have stated they are willing to work with Openreach but to date the only proposal put forward is that all customers make themselves available for an appointment which in most cases will not be required. Ofcom has documented within the Automatic compensation proposals the cost and inconvenience to customers when an engineer does not arrive for a scheduled visit and we find the proposals by Openreach likely to cause similar inconvenience and harm. We would be delighted to work with Openreach if they are able to propose a proportionate solution.

With the exclusion of the two fault categories above, Ofcom concludes that that on time repair has the potential to reach 89% over the period. Vodafone considers that Ofcom should require the glass ceiling analysis to be repeated to account for the last 12-month period – October 2016 to October 2017. Our analysis shows that there has been steady improvement in the repair function which has continued into the lacuna period. We should take advantage of the very latest data set to inform this important service decision.

We also consider that it is relevant to disaggregate the care level types in order to inform a view on ability to repair to SLA. Our analysis shows that there is a divergent position on performance which understandably shows that SLAs with longer time durations have a better performance to SLA.

### **Question 3.2: Do you agree with the proposed levels of the repair standard? Please provide reasons and evidence in support of your views.**

### **Question 3.3: Do you agree with our proposed glidepath? Please provide reasons and evidence in support of your views.**

We consider that both the proposals from the first consultation and the new proposals are relevant in setting minimum service level standards. The analysis shown in section 2 demonstrates that there is variability between the performance of the multiple service level standards and it would be appropriate to impose service floors reflective of the time differences permitted to meet a SLA. Consequently, we consider it would be proportionate and nondiscriminatory for Ofcom to set separate MSLs for the distinct service levels offered by Openreach as set out below.



Openreach SML	Present MSL	Present average performance	Y1 MSL	Y2 MSL	Y3 MSL
SML2 (one day repair)	80% (77%)	84%	83% (80%)	86% (83%)	88% (85%)
SML1 (two day repair)	80% (77%)	88%	83% (80%)	90% 87%	93% 90%
SML 3	80% (77%)	84%	83% (80%)	86% (83%)	88% (85%)
SML 4	80% (77%)	84%	83% (80%)	86% (83%)	88% (85%)

We note that Openreach in its own submission proposed that Ofcom should set the MSL at the following levels:

*"We propose that the following glidepath is more appropriate<sup>20</sup>, if Ofcom accepts our proposal for 90% (pre MBORC allowance) in Year 3:*

*Year 1: 83% (80% post MBORC allowance)*

*Year 2: 87% (84% post MBORC allowance)*

*Year 3: 90% (87% post MBORC allowance)<sup>21</sup>*

The (above) MSLs proposed by Openreach are in excess of the MSLs that Ofcom now proposes to adopt.

We further note that Openreach shares our view that "good areas should not be sacrificed for bad"<sup>22</sup>. We consider that is best achieved by ensuring that where higher performance levels exist these are not lost in quest to level the floor. We identify that SML1 has far higher performance levels and therefore the measures going forward should both recognize this situation and support their ongoing attainment.

Contrary to Openreach we do not consider that there will be wide scale transfer of users from MSL2 to MSL1. The transfer that Openreach refers to was a wholesale change from SML2 (one day repair) to SML1 (two day repair). The change by CPs therefore provides Openreach with a far longer period to resolve repairs. It is unsurprising that this transfer occurred given the higher rental charges associated with the fast repair time do not translate into an improved customer experience with more customers on this service type likely to be failed when a repair is required. Rather than CPs actively moving to SML2 (one day repair) it is our understanding that the direct opposite is likely to be the case with an SOR presently sitting with Openreach to enable FTTC to have the option of SML1 repair.

**Question 3.4: Do you have any further comments on our proposals for regulated BT's service performance for repair? Please provide reasons and evidence in support of your views.**

We have set out in our previous response<sup>23</sup> that we consider that the treatment of the MBORC allowance should be modified from before. We agree that as a safeguard for Openreach against poor performance when

<sup>21</sup> Para 209 [https://www.ofcom.org.uk/\\_\\_data/assets/pdf\\_file/0013/105115/Openreach.pdf](https://www.ofcom.org.uk/__data/assets/pdf_file/0013/105115/Openreach.pdf)

<sup>22</sup> Para 36

<sup>23</sup> [https://www.ofcom.org.uk/\\_\\_data/assets/pdf\\_file/0010/105121/Vodafone.pdf](https://www.ofcom.org.uk/__data/assets/pdf_file/0010/105121/Vodafone.pdf) response to question 5.6



extreme weather events occur that could be appropriate to exclude periods of HL MBORC. We note that the proposal is in place due to the very adverse weather conditions in 2014. This weather pattern has not been repeated. However, at the time of writing the UK was experiencing storm Ophelia the magnitude of which has not been felt for 30 years. A regime that does allow extraordinary events to be exempt is appropriate however this is not required for years that are normal. Therefore, we consider it unreasonable to establish a regime that allows for a one off weather event that occurs so infrequently.

Openreach rather honestly sets out that it uses the MBORC allowance to manage compliance with the MSL despite the lack of MBORC service effecting events. This is not the intention of the allowance and effectively creates a situation of regulatory false advertising whereby a headline rate of service quality is proposed but the actual customers experience in poor performing regions is immediately dropped by 3%.

**Question 4.1: Do you agree with our resource uplift estimates as modified from our March proposals? Please provide reasons and evidence in support of your views.**

Ofcom’s document sets out that far greater resources are required then originally proposed in the first consultation phase. An overview shows that between the two consultations Openreach has demonstrated that it requires 3% more resources yet it will deliver 5% less quality improvements.

Given that all regions are presently already supplying repair care level SML2 at rates above the proposed MSL range for the final year we assume that the additional resources are required to improve the one day repair performance in Scotland by 4.67% over the 3 years, Northern Ireland by 1.53%, North West by 1.22%, North East by 3.02%, North Wales and North Mid by 3.59%, East Anglia by 2.36% and Wessex by 1%.

SML2 (%)	Oct-Dec 16	Jan-Mar 17	Apr-Jun 17
Scotland	78.71	78.3	80.33
NI	78.44	81.23	83.47
North West	80.96	83.18	83.78
North East	77.33	81.65	81.98
North Wales/ North Mid	78.84	81.47	81.41
South Wales	75.47	82.93	85.54
East Anglia	76.34	82.05	82.64
Wessex	76.49	81.96	84
South East	81.03	82.95	85.15
London	80.45	84.93	85.73

In order to achieve the average improvement of 2.5% for each of these areas over the 3 year period, Openreach has determined that a 3% increase of total resource is required. The data required to properly review this is unavailable to respondents of the consultation. From the information we do have to hand it is difficult to comprehend, when taking the information for repair performance this year, what additional effort is required so that each and every service and region can achieve the proposed MSL by 2020/21.

It is more difficult to reconcile the requirement for each and every consumer to need to pay an additional £1/£1.40 to contribute to such a limited overall improvement.



**Question 5.1 Do you agree with our forecast as modified from our March proposals? Please provide reasons and evidence in support of your views.**

In order to determine the cost allowance Ofcom considers BT's actual forecast for network faults for the period. Ofcom does not give consideration to the level of faults that would arise in the event that a) BT had invested as intended in the preceding period on preventative network health improvement measures, b) the level of faults that would be experienced in the event that an adequate proportion of the network was regarded to have been efficiently upgraded to FTTP the MEA.

In our view Ofcom should make an adjustment to the Openreach forecast fault rate for the period to ensure that the costs are efficient and reflect the costs associated with the MEA. Under the present FAMR proposals Openreach simply has no incentives to convert its facilities to the MEA. This position is further entrenched by the ability for Openreach not pass on to consumers the higher fault rate costs associated with the continuation of the copper network.

We consider that Ofcom should include a MEA FTTP assumption in the region of 15% based on an efficient coverage of 38% of homes (which is an approximate mean average across EU Member States) for evaluated the cost base of fault repair for this review period.

**Question 6.1: Do you agree with the package of quality of service remedies we are proposing? Please provide reasons and evidence in support of your views.**

**Question 6.2: Do you agree that our proposed quality of service remedies (as revised) are objectively justified, not unduly discriminatory, proportionate and transparent? Please provide reasons and evidence in support of your views**

With respect to the proposals for repair we consider that Ofcom should make the following adjustments to its proposals:

1. While allowing up to 3% of MBORC incidents overall only permit actual incidents of HL MBORC (which are service level attainment effecting) be counted.
2. Adjust the volume forecast to account for 15% proportion of the network being the MEA FTTP
3. That Ofcom sets MSLs for each of the Openreach care levels SML1, SML2, SML3 and SML4. In practice we consider that just two different values can be set but that compliance reporting should be per MSL
4. That the WLA QoS proposals are fully supportive of the objectives of the Ofcom automatic compensation proposals and thereby retain the higher performance levels of SML1 (by setting appropriate and capability reflecting higher MSLs), and that the charge control does not include the cost of pass through for automatic compensation as this would undermine the cost incentive that that automatic compensation policy seeks to add.