



Compensating providers delivering Universal Services – Vodafone Response

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1. Executive summary

1. Vodafone is a firm supporter of initiatives that seek to widen access to improved levels of connectivity. We recognise that higher speed connections are needed in some parts of the United Kingdom, helping consumers consume content, interact and gain access to vital public services. However, any outcome which requires communication providers to contribute to the cost of extending a rival provider's network needs to be subjected to a considerable degree of scrutiny. It is essential that past as well as anticipated revenue and investment decisions are taken into account to ensure a fair outcome for all.
2. The timing and scope of this consultation are a matter for concern. At this stage, we have no clear view on the size of any broadband USO shortfall, nor who will be compelled to contribute. In particular, there are a number of initiatives underway that will have consequences for broadband delivery in the hardest to reach locations, not least BT's copper switch off, WLR withdrawal and projects to extend rural mobile coverage, which may allow wider rural use of Fixed Radio Access ('FRA') services in hard to serve locations and so reduce the total number of qualifying USO premises. In light of this backdrop, we are concerned that this consultation is taking place before any determination on a net cost burden has been conducted. It may be better to wait until a more complete picture is known before making any final policy decisions in this evolving area
3. In 2018 Ofcom published a document entitled "Regulatory certainty to support investment in full-fibre broadband"¹. This document highlighted Ofcom's commitment to stimulating long term investment in the UK telecoms infrastructure. The document outlined the need for a stable, predictable and certain regulatory landscape in order to aid investment and promote industry certainty. Regrettably, the current approach to broadband USO funding places significant 'cost' uncertainty on the industry and the very operators that Ofcom is seeking to encourage to invest in the UK. This uncertainty spans the scale, scope and timing of any eventual USO surcharge. Far from providing reassurance, these consultation proposals seek to prolong the period of uncertainty until an as yet undetermined point in the future. This is at odds with Ofcom's strategic aim of encouraging investment.
4. We have stated from our response to Ofcom's initial consultation² on the broadband universal service obligation that we do not believe any additional funding for delivering a 10Mbit/s broadband service within a £3,400 cost threshold is warranted because:
 - a. ⌘

¹ https://www.ofcom.org.uk/data/assets/pdf_file/0025/116539/investment-full-fibre-broadband.pdf

² https://www.ofcom.org.uk/data/assets/pdf_file/0020/51464/vodafone.pdf



- b. Given Ofcom's proposed cost threshold of £3,400 limits the initial build costs of the Broadband USO (with connections costing above £3,400 do not qualify for the Broadband USO) and the fact that Ofcom's have set an upper limit of £45 per month for the price that can be charged. Even using assumptions that are generous to the Broadband USO provider, when these two parameters are taken account of, the Broadband USO should not result in a cost burden to the provider.
5. Any assessment of a Broadband USO provider's costs and future revenue predictions that does result in a burden being calculated by Ofcom is only likely to occur if very conservative assumptions are used regarding future expected revenue flows. We believe having a monopoly connection to a household to supply broadband and a range of other services is very valuable. In line with the principles set out in Ofcom's consultation, this fact should be taken account of in any assessment, with additional revenues likely to flow from that connection included in the assessment of the potential future revenue streams.
6. Ofcom have incorrectly assumed that because BT have not upgraded customer connections to 10Mbit/s to date, it is not commercially viable to do so. This is a naive and theoretically view of capital investment. Organisations such as BT allocate capital expenditure to the projects with the highest potential financial returns and projects have to compete for a limited amount of capital expenditure, just because some projects are not completed or do not receive the funding does not mean they are commercially unviable. BT are also likely to have an expectation that state aid or industry funding may materialise in the absence of their own investment plan, thus deterring them from investing, even when it may be commercially viable to do so.
7. Notwithstanding our overarching view that there should be no funding deficit as a result of an NPV analysis carried out (using Ofcom's methodology in section 9 of the consultation), we struggle with the uncertainty inherent within Ofcom's consultation proposals, finding it very difficult to comment on the vast range of outcomes that could materialise. For example:
 - a. What is the scale of the broadband USO, 4,000 households? 40,000 households?
 - b. What is the scope of the broadband USO, the potential number of non-household type claims?
 - c. What information and in what form would a Broadband USO provider submit? It seems the process is more one of a Broadband USO provider making a case rather than completing templates and fulfilling pre-set Ofcom data requests (which Ofcom routinely use when gathering information).
 - d. Who will pay for the Broadband USO, the government, residential fixed telecom operators, broadband only providers, only users of the Openreach network, business fixed telecom operators, mobile telecom operators, over the top players? Although Ofcom consults here on



a broad policy, in practice we are none the wiser as to who (should Ofcom identify a funding deficit) would actually pay.

2. Questions 1-3

Question 1: Do you agree with our proposed procedures for commencing a review of a net cost of complying with universal service conditions?

Question 2: Do you agree with our proposed procedures for making an application requesting compensation for any unfair burden?



Question 3: Do you agree with our proposed procedures when making determinations when assessing a net cost claim, including our proposed approach to finality?

2.1 In paragraph 4.22 Ofcom state that:

Ofcom will consult on its proposals before making a determination on a net cost of compliance; whether it would be unfair for the Universal Service Provider to bear all or part of that net cost; and, where applicable, who should contribute to any industry fund and in what proportion;

2.2 We consider that it is wholly appropriate for Ofcom to consult on its proposals before making any determination on a net cost burden. We have set out in prior responses to the Broadband USO the level of information and scrutiny that we feel would be appropriate.³

2.3 We consider Ofcom will seriously reduce its ability to challenge Broadband USO claims if it does not specify the precise data that is required before the fact. Ofcom should specify that the Broadband USO provider must have an independent auditor in place to audit its reporting and the records used to justify any funding claim. With only one UK national USO provider, the lack of peer review is a concern that needs to be addressed, with an independent assessment of any USO costs incurred to ensure they are both fair and reasonably derived. With this in mind, we agree with the policy of only allowing only one claim per year. Permitting increased claims would potentially reduce the scrutiny and depth of investigation on each claim by Ofcom.

2.4 We have concerns regarding Ofcom's approach to finality, not re-assessing the scope of any cost burden risks the over compensation of funding. By its very nature, the NPV calculation (please see the more detailed discussion in our answers to later questions) is weighted towards the Broadband USO provider, giving rise to an increase likelihood of over-recovering their initial network costs rather than any under-recovery.

2.5 Over-recovery is more likely to occur than under-recovery because:

- The costs incurred in providing the service are largely fixed, upfront and to a high degree certain, and in any case capped at £3,400
- However the revenues used to off-set these costs and used to assess whether indeed there is a cost burden are future forecasts stretching 20 years, subject to *uncertainty* and as show in our answers to later questions very sensitive to small assumption changes.

2.6 Ofcom should take into account the recent example of the BDUK funding provided by government. In this case, conservative initial forecasts by funding receivers accepted by the funding provider led the

³ https://www.ofcom.org.uk/data/assets/pdf_file/0022/141448/vodafone.pdf



funding receiver to enjoy windfall gains. Fortunately in this case the funding mechanism did include a clawback mechanism to require funding receivers to pay back funds where their conservative initial forecasts proved highly inaccurate.⁴ What is stark and what Ofcom need to consider in this case is the scale of the BDUK clawback, approximately one third of all funding provided to BT will have to be returned via the clawback mechanism, this validates the requirement for any funding scheme to include a clawback mechanism.

3. Question 4-5

Question 4: Do you agree with our proposal on the information the Universal Service Provider should provide alongside an application to review a net cost?

Question 5: Do you agree with our proposed approach to calculating, verifying and auditing a net cost?

3.1 We consider questions 4 and 5 to be the most important of this consultation, however we believe we have been provided with insufficient information to provide an informed answer to these questions. At this stage we are not yet clear what Ofcom are actually proposing in sufficient detail. For example Ofcom state:⁵

"We are proposing to specify in the funding regulations information that the Universal Service Provider will be required to submit."

"We do not propose to specify in the funding regulations a detailed approach to calculating and verifying a net cost but we do propose to set out the matters which Ofcom considers appropriate when calculating a net cost"

3.2 Question 4 clearly asks us whether we agree with Ofcom's proposal on the information the Universal Service Provider should provide alongside any application to review a net cost. However, Ofcom state in their consultation that they do not propose to specify a detailed approach to calculating and verifying the net cost burden. Therefore the only thing we can meaningfully comment on are the matters which Ofcom might consider appropriate when calculating a net cost burden.

3.3 Using the experience of the BDUK funding program (being the most recent example of subsidies being provided to BT), it has been shown that calculating the costs to provide broadband services, the revenues attributable to those services and the take-up of those services is far from straightforward. One of the many issues that came out of the numerous government select

⁴ BDUK report from last time

⁵ Ofcom's Consultation paragraph 5.1



committees questioning of BT's participation in the BDUK program was the need for clear, transparent and detailed information.

3.4 We would describe Ofcom's proposed approach to the information requirements and calculation of the net burden to be 'passive'. It fails to set out clear, concise, detailed information requirements (providing an evidence base for any numbers used) or indeed the very calculations which must be completed. Whilst we understand that the scale, nature and timing of the USO is uncertain, if there is a significant claim and if Ofcom is to assess it and fulfill its public interest duties, it should be clear to all from the outset precisely what information is required, how that information is evidenced and what the process is for calculating, verifying and auditing that information. If the end result is a wealth transfer from rival CPs to BT with the purpose of extending or replacing its access network, then this entire exercise needs to be documented in significant detail from the outset.

3.5 Ofcom state that:

The draft funding regulations therefore specify that the Universal Service Provider must provide:

a) Its own estimate of the net cost of complying with the conditions;

b) The calculation used to arrive at that estimate;

c) An explanation of the methodology it has used when performing that calculation;

d) The accounts or other information which serve as the basis for the calculation of the net cost;

e) An explanation of the steps taken to verify the information on which the calculation is based;

f) The evidence that the net cost was efficiently and necessarily incurred;

g) Any other information identified as appropriate by Ofcom having regard to the facts and circumstances of the case;

h) An explanation of why the Universal Service Provider considers the identified net cost to be an unfair financial burden alongside any supporting information to justify its explanation.

3.6 This gives all the power, control and scope to the service provider to selectively provide the information and transparency that is most favourable to their claim. This is very different to the normal way in which Ofcom operate when calculating costs, revenues and NPV projections. When carrying out charge controls, market assessments, or any other formal regulation Ofcom uses its legal information gathering powers and requests specific information using the s135 or s136 information gathering process. We have clear examples from the recent past in the sphere of regulatory accounting, when BT have been provided latitude to self-select numbers, the outcome can prove very self-serving, resulting in Ofcom's failure to adopt the published output, re-statements and a general loss of confidence in all the information published.



- 3.7 Using a proactive, preset process for requesting specific information determined and decided by Ofcom in advance ensures that calculations and conclusions are reached in a way that is actively controlled by Ofcom. As it stands Ofcom's proposed approach fails to take control, lack the necessary rigor and runs the substantial risk that all participants (save the applicant) will have no confidence in the process and as a consequence no confidence in the outcome.

4. Question 6

Question 6: Do you agree with the proposed factors we will consider when assessing an unfair burden?

- 4.1 We believe that Ofcom need to consider the returns and regulatory approach they have taken over the past 10 years in areas where it is now being proposed that USO service providers (i.e. BT) are potentially to receive additional funds.
- 4.2 There are two issues that we believe are directly relevant to whether or not BT should be deemed to have a net deficit or cost burden in providing broadband services. Firstly Ofcom need to consider what 'excessive' profits over their regulated cost of capital BT have made in the areas where additional funding is being potentially considered, and secondly Ofcom need to consider whether BT actually invested in network assets to provide higher speeds of broadband in these areas when the costs in the charge control implemented in these areas allowed BT to do so.

⌘

4.3 ⌘

4.4 ⌘.

4.5 ⌘

Figure 1 : ⌘

Ofcom's regulatory approach assumes BT would have invested in this market

- 4.6 When Ofcom constructed the group of costs for wholesale broadband services in rural areas (currently referred to as market A) they found that the underlying assets (SDH, ATM network, and the exchange DSLAM equipment) were heavily depreciated, such that the mean capital employed by BT in the market was very low. Modelled in the usual way this would have led to lower wholesale charge controlled prices. However Ofcom 'uplifted' the cost of this asset base in their cost model to



enable/or because BT were investing in 21CN equipment and Ofcom did not want to discourage investment.⁶

“The last adjustment was necessary because a number of the assets used in the WBA market are fully depreciated. This is not consistent with our “hypothetical ongoing network” (HON) assumption, where in the absence of investments in 21CN, BT would have had to replace these depreciated assets. As a result, some of the asset values in BT’s data were below the level consistent with what we believed a “steady state” value would be. Specifically, we believe that, on average, assets in a steady state would be half way through their economic lives. As such, BT’s financial data were unsuitable as a basis for projecting the costs of a hypothetical ongoing network.”

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“BT’s costs for maintaining the broadband network may be increasing due to the age of the equipment and this could be reflected in its view on efficiency. However, the HON adjustment allows for aging assets to be replaced and so higher costs related to maintaining an aging network would not arise. We believe this provides some support for a higher efficiency assumption to reflect the lower operational costs arising under our HON approach as compared to BT’s actual network costs, though we also note that we have increased asset lives in our model, and this could reduce the effect of this.”

- 4.7 Ofcom’s policy decision allowed BT to recover additional depreciation charges and cost of capital on assets that did not exist by producing a pricing model that inflated the wholesale broadband access cost stack. The purpose of this was to ensure that when BT did invest they would receive a return. However, choose instead to take the extra returns and not invest, despite consumers in this market often paying the most for their retail broadband and suffering the slowest speeds.
- 4.8 In the Broadband Access Market, Ofcom ~~3~~ did not compel any level of investment in BT’s rural network, it simply created an overhead to fund that investment, with that investment failing to materialise.~~3~~.
- 4.9 Ofcom need now to take account of the opportunity and past funding that could have occurred before any USO funding decisions are made. In many cases past investment would have taken many premises outside the scope for USO consideration, with consumers enjoying better broadband speeds much earlier had BT been required to invest the additional fund that Ofcom’s WBA charge controls had allowed for.

⁶ Paragraph 5.66 https://www.ofcom.org.uk/data/assets/pdf_file/0024/36942/statement.pdf

⁷ Paragraph A7.190 https://www.ofcom.org.uk/data/assets/pdf_file/0027/63675/statement_annexes.pdf



5. Question 7-9:

Question 7: Do you agree with our proposed approach to determining whether an industry fund should be set up?

Question 8: Do you agree with our proposed approach to determining which providers will contribute to any industry fund?

Question 9: Do you agree with our proposed approach on calculating contributions from fund contributors?

- 5.1 We feel unable to comment in full on these questions due to the lack of detail that has been made available to us at this point. At this point it is unclear whether government funding will be allocated to the provision of services in these areas and if so, what that level of the funding will be. It is also unclear whether an industry fund will be required, and if it is required who Ofcom deem appropriate to include in the fund.
- 5.2 As a point of principle we believe it Ofcom should be minded against any outcome that requires rival CPs to fund the extension or upgrading of a rival CP's access network as any level of funding contribution made will be lost to a CP's own investment priorities. Given BT's dominance in many markets, asking CPs with far smaller market shares to contribute to BT network upgrade is especially concerning.
- 5.3 This consultation includes only the very highest of principles in this regards and as such we consider the uncertainty of the outcomes from those high level principles to be so wide ranging and difficult to quantify. The level of funding required could be between £0 and an infinite amount, with the level of any Government funding equally uncertain.
- 5.4 For the moment all CPs are potentially on the hook to fund BT's network upgrade. Ofcom comments on 'proportionality' and 'administrative burden' are sufficiently vague, making it unclear who will contribute and at what level. Will Ofcom seek to exclude some potential industry contributors simply because it increases their administrative burden? Such an outcome would obviously have consequences for the remaining contributors. The continued reference of the term 'case by case basis' is concerning and gives the impression Ofcom will make its decision at the time, without providing clear guidance ahead of any formal steps to establish a fund. Could this permit Ofcom to take an inconsistent approach over time?



6. Question 10-12:

Question 10: Do you agree with our proposed approach to collecting contributions to an industry fund?

Question 11: Do you agree with the proposed process by which we would compensate the Universal Service Provider?

Question 12: Do you have any comments on the specific provisions of the draft funding regulations?

6.1 As we have discussed in the previous sections the level, timing and actual requirement of any funding is currently wholly uncertain. It is important that if Ofcom do deem that industry funding is required that the request for the funding to the funding providers is first consulted on and then any deemed funding contributors are given the appropriate time to actually make the contributions.

6.2 Ofcom need to take account of the considerable brand benefits that stem from being the national USO provider. In 2006, Ofcom concluded that:

“Benefits from providing universal services arise primarily from brand image and advertising on PCBs. Ofcom estimated that the benefits have remained broadly stable. We estimated the current costs of USO for BT are around £57-74m and the benefits are around £59-64m. Ofcom has concluded that these estimates are reasonable and believes that there is unlikely to be an undue financial burden currently on BT as a result of USO”⁸.

6.3 We anticipate similar brand benefits exist today and Ofcom should ensure this benefit is quantified and included within any future calculations.

7. Question 13-16:

Question 13: Do you agree with our proposed approach to the choice of the counterfactual for the calculation of a net cost of the broadband USO?

Question 14: Do you agree with our proposal to use a NPV methodology to calculate a net cost of the broadband USO?

Question 15: Do you agree with our proposed reporting requirements in respect of the broadband USO?

Question 16: Is there anything else you would like to tell us about the proposals set out in this document?

⁸ 1.17: https://www.ofcom.org.uk/__data/assets/pdf_file/0021/34266/statement.pdf



- 7.1 In answering these questions and in order to put real perspective around any future broadband USO claim we consider that it would be very useful to provide a high level simplified net present value calculation to show:
- (a) the likelihood in reality of a funding deficit is remote; and
 - (b) the calculation is highly subjective to future forecasts that are largely unknown at this point in time.
- 7.2 In carrying out an NPV analysis, as indicated by Ofcom in the consultation, the important elements of the calculations are:
- (a) The initial cost of the broadband upgrade, this is the technical equipment and network upgrade that is required to support an access network speed of 10Mbit/s;
 - (b) The on-going incremental costs of maintaining the new equipment over and above maintaining the existing equipment;
 - (c) The on-going incremental revenue attributable to the upgraded Broadband service;
 - (d) The on-going incremental revenue from other services sold to the household as a result of the faster speed broadband the household now receives;
 - (e) The increase in brand awareness, value and reputation as a result of having an improved network serving consumers with a higher level of service than they otherwise would have received;
 - (f) The cost of capital and discount rate used in the calculation.
- 7.3 At the time of performing the calculation of the net cost of providing the broadband, only the costs described in (a) would be certain. All other major net cost assumption inputs would be unknown and entirely based on estimates of uncertain future outcomes. Ofcom's proposed process sets out that the designated Broadband USO provider should perform these calculations, heavily relying on future uncertain predictions.
- 7.4 In order to set context and understand the potential scale of the deficit of the Broadband USO as discussed below we have set out a high level view below. This view uses cost and revenue estimates that, in our view, favour the Broadband USO provider to show that even if the Broadband USO provider does incur a high level of costs and lower than expected revenues, the chance of there being a funding deficit is unlikely.
- 7.5 Our cost assumptions are detailed below:
- (a) The initial cost of the broadband upgrade, this is the technical equipment and network upgrade that is required to produce 10Mbit/s. Although we do not know what the cost precisely are, we know that the maximum cost threshold is £3,400. In our illustration we will assume an average of £3,000, this is a generous cost assumption near the upper end of the scale.



- (b) The on-going incremental costs of maintaining the new equipment over and above maintaining the existing equipment. Considering the upgrade is likely to be simply new electronics equipment it is likely that in fact the upgrade saves the Broadband USO provider maintenance costs relating to older equipment (legacy copper) and enables them to replace that equipment, which is in all likelihood more costly to maintain. However, for this illustration we will assume no additional costs or cost savings.
- (c) The on-going incremental revenue attributable to the upgraded Broadband service. Currently Broadband in these areas attracts monthly retail revenues of appropriately £25, Ofcom in its last consultation placed a £45⁹ per month revenue cap on the amount a Broadband USO provider can charge for 10Mbit/s services. In this illustration we will assume incremental revenue of £20 and we will not increase this by inflation over the period of the NPV analysis.
- (d) The on-going incremental revenue from other services sold to the household as a result of the faster speed broadband the household now receives. As Ofcom states, increasing broadband from less than 2Mbit/s to 10Mbit/s enables the household to receive other services such as streamed TV. We believe it is reasonable to assume incremental revenue from TV services sold by the Broadband USO provider to the household. BT charge incremental revenues of up to £50 for its TV services, however in this illustration we have assumed only £5 per month and not inflated this amount over the period of analysis.
- (e) The increase in brand awareness, value and reputation as a result of having an improved network serving consumers with a higher level of service than they otherwise would have received is valuable, not least because it enables the Broadband USO provider to sell more services to customers. To be conservative we have not added any additional revenue for this benefit.
- (f) The cost of capital and discount rate used in the calculation. This changes over time and its calculation is subject to many input assumptions, however the trend is for the regulated cost of capital to reduce in line with the risk free rate and there is a valid argument that the risk associated with the provision of Broadband in USO areas is even less risky than delivering telecom services in other areas that are subject to increased competition. In our illustration we assume a cost of capital of 7%.

7.6 Using all of the assumptions explained above we calculate a positive net present value calculation using a simplified method over a 20 year period. For Ofcom to find any cost burden for a Broadband USO provider very generous (to the broadband USO provider) modelling assumptions would need to be used, something we believe would be unrealistic and would fail to stand up to any kind of detailed scrutiny.

⁹ Reducing this amount by small variations makes little difference to the conclusions, especially when considering the costs of delivery could be less and the benefits from other services could be higher.



7.7 The simple fact is that having sole access to a household to provide broadband, telephony and other services for a prolonged period is a lucrative proposition that should not be underestimated.