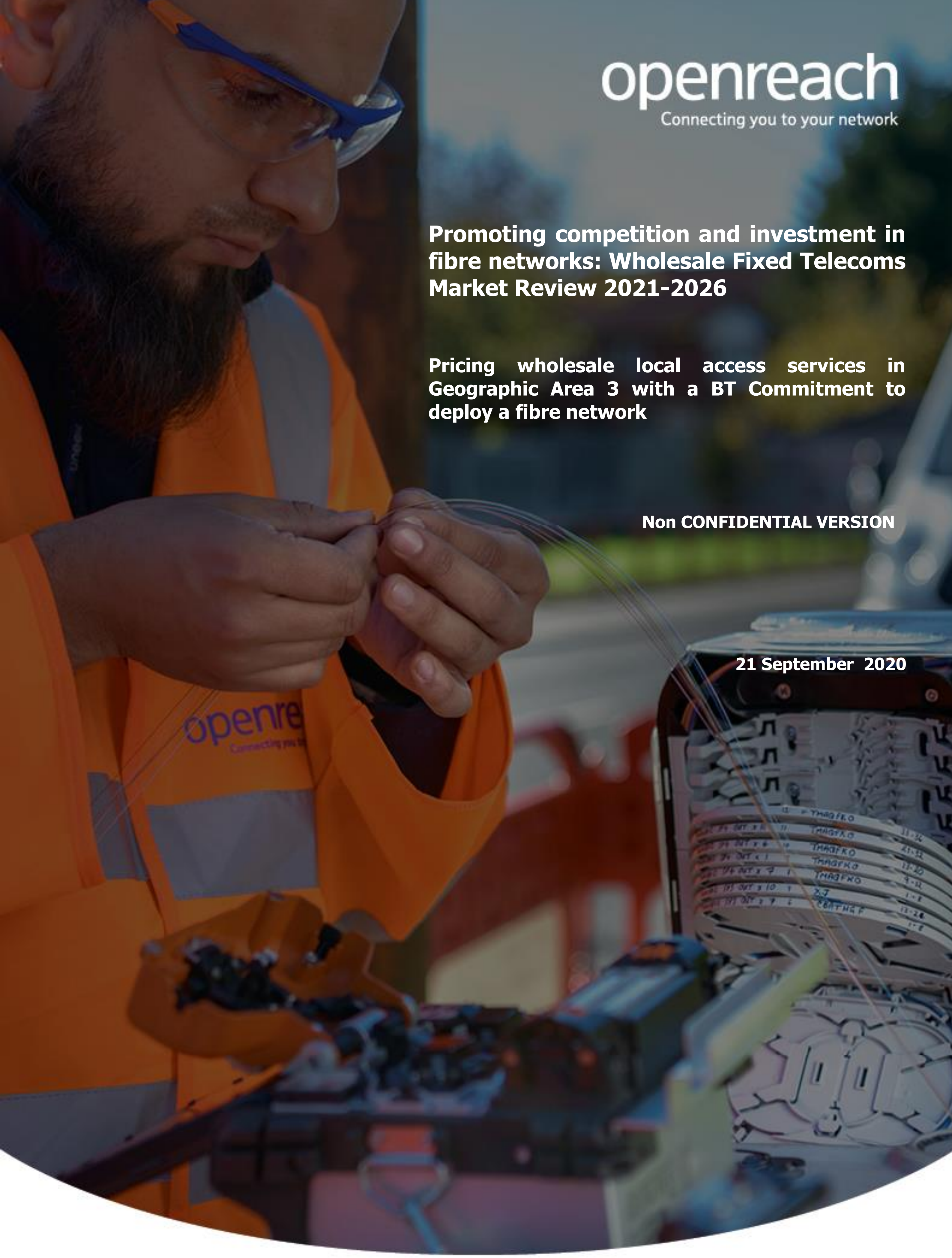


openreach
Connecting you to your network

Promoting competition and investment in fibre networks: Wholesale Fixed Telecoms Market Review 2021-2026

Pricing wholesale local access services in Geographic Area 3 with a BT Commitment to deploy a fibre network

Non CONFIDENTIAL VERSION

21 September 2020

Foreword

This response is provided by Openreach Limited[1]. Openreach is a wholesale network provider. We support more than 600 Communications Providers (CPs) to connect the 30 million UK homes and businesses to their networks. We sell our products and services to CPs so they can add their own products and provide their customers with bundled landline, mobile, broadband, TV and data services. Our services are available to everybody and our products have the same prices, terms and conditions, no matter who buys them.

[1] Openreach Limited is a wholly owned subsidiary of BT Group Plc.

Contents

1. Executive Summary

Key points

Openreach has announced bold targets to deploy FTTP across the UK at scale and pace. Our aim is to have passed 20m UK homes with FTTP by the mid-late 2020s. As part of this, we have committed to Ofcom that we will have passed 3.2m homes in Geographic Area 3 by March 2026. The sizeable investment required to deploy and connect customers to this network will have a long payback. We have therefore made our overall build target and the specific Area 3 commitment on the assumption that we will face a supportive regulatory framework both in the upcoming 5-year market review period and over the longer-term.

This consultation proposes a regulatory approach to the pricing of WLA services in Area 3 until 2026 that aligns with the proposals for pricing in Area 2, set out in Ofcom's January 2020 consultation. We welcome this. However, we would request greater clarity and certainty about how price regulation would be applied after 2026. Specifically, and in line with our position in Area 2, Ofcom should signal that the proposed 2021-26 pricing framework – i.e. CPI indexation of anchor services and pricing freedom on higher bandwidth access services – is expected to endure for at least one further review period – i.e. until 2031 – and be clearer about the principles it would follow in considering when and how it might apply any additional price regulation beyond that point to take account of the 'fair bet' principle.

1.1 We share Ofcom's objective of ensuring UK consumers and businesses can access fibre-based ultrafast access services and have announced bold deployment targets for Fibre to the Premises (FTTP). Meeting our overall build target of passing 20m homes with FTTP by the mid-late 2020s and the specific Area 3 build commitment of passing 3.2m homes by March 2026 will require significant upfront investment at a time of economic uncertainty. The fundamentals driving our decisions to invest are well understood: we need to expect that we can generate sufficient incremental value from new FTTP connections to provide investors with a reasonable return over a reasonable timeframe[2] on the costs of building the network and supplying services to customers. But the risks and uncertainties within the case are significant: costs may exceed expectations at the outset given the scale of build planned and the range of locations we will be building to and looking to connect; willingness to pay for the full range of capabilities of the new network is as yet unproven meaning the pace of adoption may be slower and/or opportunities to grow average revenue per connected user (ARPU) more limited than we need; and the scope and intensity of competitive build is unclear, challenging any assumptions on the long-term utilisation of assets.

1.2 All potential investors in ultrafast fibre networks will need to make judgements on these and other factors in making decisions about where and when to invest, balancing the potential for upside outcomes against downside risk factors. But in this uncertain environment, there is a heightened need for clarity around the regulatory framework and a need to minimise the scope for unexpected changes in the regulatory approach that reshape achievable investment outcomes before investors have earned a fair return.

[2] Our target return to support investment is at least ✂%over 20 years based on our calculated cost of capital allowing for systematic risks of the FTTP investment

1.3 We welcome Ofcom's further consultation on its approach to regulating prices of WLA services in its defined Geographic Area 3 to the extent this (i) establishes clear rules around the pricing of WLA services for the next 5 years and (ii) considers how the longer-term regulatory framework may be applied and how this could impact prices and the level of returns that could be achieved over the lifetime of the investment. But while we strongly support the proposed pricing structure for the next 5 years, which would align Area 3 prices with those proposed in the rest of the UK[3], we would look for further clarity and detail in the final statement around the longer-term approach to ensure that our investors are confident they are taking a fair investment 'bet' that – based on their judgements about future risks and opportunities – gives them an expectation of cost recovery, including a fair return. It would be helpful, for example, for Ofcom to set out in more detail the principles they would consider when deciding if, when and how to intervene.

1.4 In requesting greater clarity around the longer-term framework, we have concerns about Ofcom suggesting it could adopt some sort of long term "RAB approach" to act as a regulatory funding mechanism for our investments in Area 3. In particular, such mechanisms rely on stable and predictable customer volumes and we believe that Ofcom's outlook for Area 3 understates the scope for competitive entry and the resultant risk that we will experience line loss to entrants.

1.5 We are also concerned that the longer-term modelling approach Ofcom describes in the consultation could, if "re-based" every 5 years with the aim of adjusting prices to target cost recovery over a 20-year period spanning different review periods, tend towards "rate of return" regulation over the life of these investments. At the very least, such an approach would seem to limit the opportunity to earn the level of upside returns we consider to be necessary to support the investment case given the broad range of downside risks we have identified - including risks and uncertainties around costs, execution/timing of build, demand and willingness to pay for the full capability of FTTP lines, as well as volume risks from line loss to entrants. While we do not think that Ofcom is intending to establish "rate of return" regulation and makes broad reference to efficiency incentives and to the principle of the 'fair bet', this simply reinforces the need for Ofcom to provide greater clarity on how its long-term approach would allow for the risks and uncertainties faced by investors today. l.

1.6 Our overall view is that rather than attempt to implement a separate modelling approach to apply within Area 3 over the longer-term, Ofcom should signal that it will follow exactly the same long-term framework that it envisages would apply in Area 2 should regulation be required:

a) First, we believe that Ofcom should signal that the pricing framework proposed for the period from 2021 to 2026 – i.e. with direct constraints limited to CPI-0% real term caps on the defined anchor services and flexibility on pricing at higher bandwidths – is likely to endure for at least one more review period. As in Area 2, this approach will promote entry and will provide stability across a period of cost volatility as fibre is deployed, lines are migrated and existing network assets begin to be retired. Furthermore, while we may have a different view to Ofcom on the scale of competitive entry within Area 3 and the constraints this may place on Openreach pricing of WLA services over the short and longer-term, the anchors will clearly protect customers from any risk that they would face higher real terms prices if competition is more limited. We also note that even on Ofcom's own modelling – appropriately adjusted as set out below - there is a clear case for at least two periods of indexation to ensure a long-term expectation of cost recovery.

[3] Subject to concerns about Ofcom's proposal to introduce a consent process for any geographical pricing of FTTP services within Area 3

b) Second, Ofcom should clarify how it will have regard to the 'fair bet' principles in setting any additional pricing constraints beyond 2031. This principle requires that future regulation takes account of the risks and uncertainties faced by investors at the point the bet is placed such that their expectations of outcomes and not adjusted after the event.

Ofcom's cost modelling and analysis

1.7 Notwithstanding the points above, we have also reviewed Ofcom's modelling approach in assessing whether the adoption of Area 2 pricing remedies in Area 3 in the 2021-2026 period would be consistent with an "expectation of cost recovery".

1.8 Ofcom's approach essentially looks to forecast the 'shortfall' in the incremental case to deploy fibre to 3.2m homes in Area 3 (incremental value created less incremental costs) and then consider whether the expected path of revenues on existing services for the next five years, based on the proposed price levels for anchor services, would generate sufficient additional value to eliminate the shortfall. This exercise requires Ofcom to make assumptions about its regulatory approach after 2026 with two scenarios modelled: ongoing real term flat anchor prices for one more period and anchor constraints based on flat nominal prices from 2026. This exercise is primarily aimed at assessing whether the pricing in the first period seems broadly reasonable, but it may also provide some prior indication of how pricing from 2026 may be set. Based on Ofcom's modelling as summarised in figure 3.1 in the consultation, we are concerned with the suggestion that adopting flat nominal pricing from 2026 may be consistent with cost recovery and closer to base case outcomes than allowing a second period of real terms flat pricing.

1.9 We have identified that Ofcom should update its modelling analysis to adjust for factors where there is some inconsistency and/or errors in the inputs used:

a) the shortfall model includes FTTP connection and build costs that are inconsistent with Ofcom's explanation in the consultation of the costs it has used;

b) the model showing the value of indexation uses a lower X as an input from the CPI-X model, explained in its clarification note of 11 September, than it should have used (-2.75% rather than -3.75%)

c) Ofcom has not included its intended accelerated depreciation adjustment in deriving X in the CPI-X model,

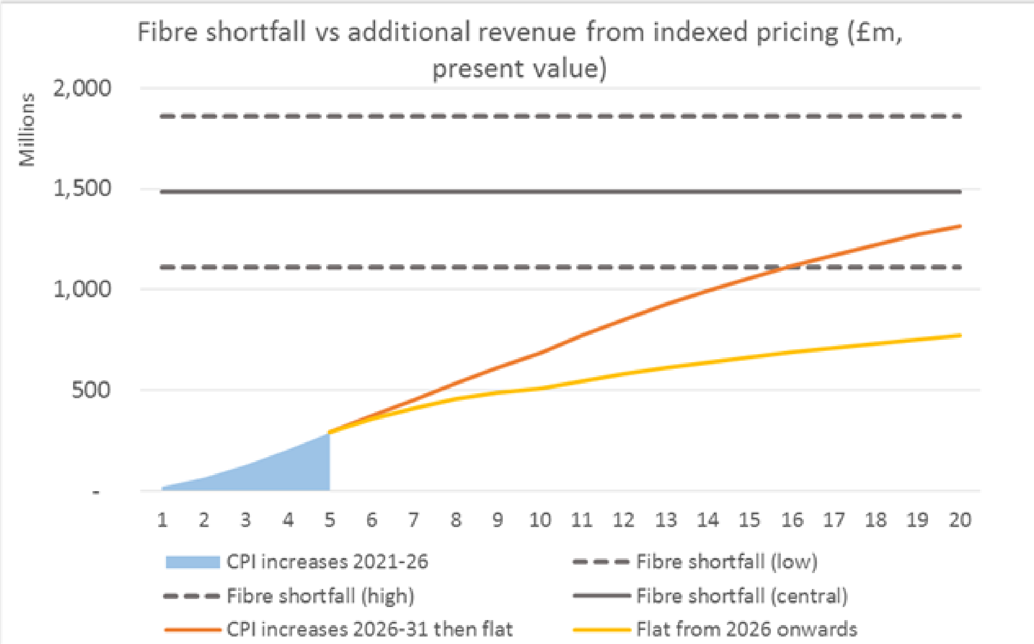
d) Ofcom has made no allowance for line loss in its modelling even though this is expected; and

e) Ofcom has used inconsistent FTTP volumes in different parts of its modelling.

1.10 On an updated view, the proposed pricing approach for the upcoming 5-year charge control period is even more clearly consistent with an expectation of longer-term (20-year) cost recovery. Further, the updated view supports extending the period of indexation to at least two charge control periods (consistent with Ofcom's approach to Area 2).

1.11 In Figure 1 below, we re-present the graph shown in Figure 3.1 in the consultation but with the five inconsistencies / errors corrected. This clearly shows that following Ofcom's own modelling logic the projected shortfall on the 3.2m investment is much higher and the intersection point for cost recovery is much further in the future and only for the lower shortfall scenario (by year 16).

Figure 1: Corrected Fibre shortfall and additional revenue estimates over 20-year investment lifetime for central cost scenario (net present value, £m).



Source: Output from Ofcom models, adjusted by Openreach for the errors listed above

1.12 In Ofcom's published analysis it estimates that indexation contributes 26% of the shortfall by year 5 (one charge control period) and 67% by year 10 (two charge control periods). Correcting Ofcom's published estimates to correct for the five errors / inconsistencies, the corresponding contribution values are 19% and 45%. Further, even after 20 years, the second period of indexation would not result in complete recovery of the shortfall. On this basis Ofcom's analysis would strongly suggest that at least two periods of indexation is warranted.

1.13 Ofcom has had to make assumptions in calculating the estimated shortfall and value of indexation. A number of these assumptions appear to be quite aggressive. For example, Ofcom assumes that 4.8% opex efficiency can be achieved year on year for 20 years; it is difficult to imagine a world in which such high levels of efficiency can be achieved over such a prolonged period. We would suggest a more realistic assumption for efficiency, more in line with long term productivity trends, is more appropriate in this case given the 20-year analysis time horizon. Further, the assumed FTTP connection costs seem to be particularly low compared to our business case values. A more measured and prudent approach to these (and other modelling parameters laid out in section 4 below) would suggest that, based on Ofcom's analysis approach, there is little risk that two periods of indexation would result in over-recovery.

Other issues

1.14 Our detailed views regarding Ofcom's proposed changes to the reporting obligations proposed in the January consultation are outlined in the BT Group response.

1.15 We also make a number of detailed comments regarding changes proposed here to the legal instruments proposed in the January consultation.

2. Ofcom's proposed approach to pricing WLA services in Area 3

Question 3.1: Do you agree with our approach to assessing the BT Commitment and proposals for pricing WLA services in Geographic Area 3?

Key points

2.1 We agree with Ofcom's proposals for pricing MPF, 40/10 FTTC and 40/10 FTTP rental services in Geographic Area 3 as set out in the consultation and the draft legal instruments. Introducing safeguard caps that keep wholesale rental prices for existing anchor services flat in real terms from 2021, allow a premium on the new FTTP anchor and leave flexibility for our pricing of higher bandwidth connections can support our investment case and underpin our commitment to have built FTTP to 3.2m UK homes in defined Area 3 postcodes by March 2026 as part of our wider target of passing 20m UK homes in total by the mid-late 2020s.

2.2 However, these proposals would only set out in detail the regulation that would apply for the first five years of an investment case where we would look to earn a reasonable return over a longer term (c 20-year) period. We therefore also need to make assumptions about how regulation will be set after this point in order to provide confidence that we are placing a 'fair bet' in making these investments – i.e. that future regulation allow us the opportunity to earn returns above the cost of capital for these investments where these are necessary to offset the risks we see today of returns falling beneath this level.

2.3 Ofcom positions its proposals as a forecast "RAB approach". Under this, Ofcom suggests that the aim of pricing regulation is to fund a projected 'shortfall' in the commercial incremental FTTP investment case for Area 3 – i.e. prices of existing anchor services are being allowed to rise above costs to provide an expectation of cost recovery on the FTTP investment. Ofcom then suggests the forecast RAB approach could endure over the longer-term with Ofcom "re-basing" its calculation of the projected 'shortfall' at each 5-year review point and reassessing the level of regulated prices consistent with the expectation of cost recovery.

2.4 This might suggest a series of course corrections based on updates to the outlook with the aim of landing lifetime returns at a target level of returns, but no higher. We do not therefore believe this approach would provide an opportunity to earn and keep upside returns on the investment to build within Area 3 and could, therefore, be inconsistent with the fair bet principle.

2.5 We therefore propose the same regulatory model is adopted in Area 3 as we are seeking in Area 2: Ofcom should signal its expectation that the regulatory pricing structure proposed in this consultation will endure for at least two review cycles (ten years), confirm that it will allow fair bet upsides in setting any future pricing regulation and set out the principles by which it would assess when and how it would intervene.

2.6 While we welcome Ofcom's broad acknowledgement that some level of alternative network build in Area 3 is viable – and we note that this point was also made by a large number of alternative network providers who indicated they are or have plans to build in Area 3 already - we do not believe it is necessary to introduce a consent process for introducing any geographic variation in prices within Area 3. This is consistent with our position on Ofcom's proposals introducing a consent process for geographic variations on any FTTP rental services within Area 2.

Ofcom's proposed approach is preferable to a post-build RAB approach

2.7 In the January 2020 consultation, Ofcom put forward two potential approaches to regulation within Area 3: a "forecast RAB approach" and a "post-build RAB approach". As set out in our response in January and further comments below, we do not agree with Ofcom's overall positioning of Geographic Area 3 as "non-competitive" -and note that a number of other stakeholders made the same point in their WFTMR response - with the implication that there will be limited, if any, competitive build. As we explain further below, we therefore do not view any longer-term "RAB approach" – akin to the type of models used in other regulated sectors where volumes are relatively stable and predictable over the long term – as suitable for Area 3. However, we nevertheless welcome Ofcom's proposal to not pursue the "post-build RAB approach" which would have initially reduced prices within Area 3 and only allowed them to increase once we had deployed FTTP network. We believe this would have undermined the case to invest for us and for other entrants.

2.8 Ofcom's new proposals would introduce the following regulation for the pricing of WLA services in Geographic Area 3 in the period running from April 2021 to March 2026:

a) Safeguard anchor controls on MPF and FTTC 40/10 rental prices at CPI+0;
b) A new anchor control on FTTP 40/10 rental prices, set at a modest premium (£1.50-£1.85) to the combined MPF plus FTTC 40/10 rental price, with the regulated anchor moving to FTTP once coverage thresholds within an exchange area have been met; and
c) Pricing flexibility on all rental prices for Openreach WLA access services at bandwidths above 40/10 (covering FTTC, FTTP and G.Fast) subject to compliance with a fair and reasonable pricing requirement.

2.9 We agree with this proposed approach for the pricing of WLA services in Geographic Area 3 which, along with the separate proposals to adjust access supply remedies to support switchover and copper retirement, would be supportive of our case to deploy to reach 3.2m homes in Area 3 postcode sectors by March 2026.

2.10 However, while the proposals for pricing within this market review period are welcome, the case to deploy FTTP requires an expectation of cost recovery over a much longer time frame. Ofcom makes some high-level comments about its likely longer-term approach to regulating the price of WLA services within Area 3. But we still need and seek greater clarity about the regulatory framework beyond 2026 to provide assurance that we are facing a 'fair bet' on our investment decisions today.

2.11 This is precisely the same issue faced in Area 2 where the potential for future regulatory intervention to restrict pricing levels and, as a result, limit revenue opportunities creates uncertainty about the extent to which upside outcomes on investment returns can offset identified risks of downside outcomes. We therefore look for the same solution in Area 3 as in Area 2 to address the longer-term uncertainty across the UK, namely:

a) To provide a stronger indication in the final WFTMR statement that the proposed approach to pricing WLA services will endure for at least 10 years; and
b) To provide clarity that any additional regulation applied beyond that point would allow a fair bet by not removing the opportunity to earn and retain a level of upside returns on the investment, required to offset downside risks faced today.

2.12 In this Section, we explain:

a) The fundamentals of our case to invest in FTTP in Area 3;
b) The level of returns we need support the case;
c) How assumptions about future regulation could impact expected returns;
d) What assurances we are therefore seeking about long-term regulation;
e) Why we do not believe a forecast "RAB approach" can provide such assurances; and
f) Why Ofcom's proposals on geographic pricing restrictions are unnecessary.

The fundamentals of our case to invest in FTTP in Area 3

2.13 The fundamentals of the case to invest in FTTP are the same regardless of the geographic area: investors need to believe they can generate sufficient value from the deployment of ultrafast-capable FTTP connections to cover the cost of deploying the network and supplying access services to UK residential and business premises. As Openreach would be deploying FTTP over the top of existing copper/FTTC connections, our case to invest has to focus on the incremental value that could be generated and whether this is sufficient to cover deployment and supply costs.

2.14 In the consultation, Ofcom rightly frames this as us needing to have an "expectation of cost recovery" and, in its modelling, assesses the incremental case to overbuild FTTP to 3.2m home in Area 3 and looks at the scope for costs of build and ongoing supply to be recovered across a 20-year period. In Section 4, we identify a number of adjustments that are needed to Ofcom's modelling to ensure consistent logic is adopted in driving model outputs for the purpose of considering cost recovery requirements for the 3.2m build. We also comment on key modelling assumptions highlighting where there are material differences with our views. But notwithstanding these comments, the broad model structure provides a reasonable start point for illustrating the investment challenge faced, in that it:

a) Seeks to capture estimates of the incremental costs associated with the new network: i.e. costs of network deployment, provisioning of lines and ongoing operation of access services;
b) Identifies potential sources of incremental value that could be extracted relative to ongoing supply of access services over existing network connections; and
c) Considers a timeframe for cost recovery (20 years) broadly in line with investor requirements for payback on upfront deployment costs.

2.15 Our internal modelling used to consider the strength of our investment case follows a similar structure to help us consider whether we would have a reasonable expectation of generating sufficient incremental value from building FTTP to give investors an expectation that they will get a reasonable return on their investment and considers the following sources of value:

a) Scope for retaining lines on our network that might otherwise migrate to new fibre network builders or other technologies;
b) Scope for selling higher bandwidth services at higher prices and driving uplift in Average Revenue Per User (ARPU); and
c) Scope for reducing operating costs through provision of services across higher capability access lines.

2.16 With uncertainty over costs and the scale of future value opportunities and risks, we then have modelled a range of different scenarios that drive a range of potential outcomes and enable us to assess the strength of the case to invest reflecting on risks and uncertainties. Under some scenarios, there is no case to invest as projected returns would be beneath the cost of capital relevant to this investment. Under others, projected returns will be above the cost of capital. By applying judgement to the relative likelihood of each scenario, we can drive a view of the expected, probability-weighted outcome which ultimately shapes our investment decision: i.e. can we tell our investors that we *expect* the investment to deliver sufficient returns to support the case to invest in FTTP?

The level of returns required to support the investment

2.17 Our parent and investor, BT Group, will require expected returns to be at least equal to the cost of capital relevant for this specific project. That is, taking account of systematic risks relevant to a sizeable investment of this type with higher operational leverage in services with higher income elasticity than other regulated Openreach access services, the cost of capital should be higher. This has been calculated as ✂%. ✂.

Assumptions on future regulation

2.18 Ofcom identifies that the investment case for FTTP will be shaped by assumptions about how future regulation could impact pricing. In its consultation, Ofcom's firm proposals are limited to the regulation of WLA access prices from 2021 to 2026. But Ofcom acknowledges that any consideration of cost recovery of the FTTP investment needs to make assumptions about the future level of regulated prices. Ofcom models two specific scenarios:

a) Prices for the safeguard anchor rental services – MPF and 40/10 FTTC – are allowed to stay flat in real terms until 2031 and are then held flat in nominal terms for another 10 years; and
b) Prices for these services are capped at the 2026 nominal price for the remaining 15 years of the model.

2.19 In both cases, the incremental ARPU earned on lines that switch to FTTP follows the same assumed high, low and base path in each year implying that the level of the premium is not assumed to be directly regulated.

2.20 However, Ofcom is clear that in using these assumptions in its modelling exercise it is not fettering its discretion about future regulation.

2.21 Our decision on whether to invest therefore has to consider whether, when and how future regulatory decisions may be taken that have the effect of constraining price levels for any WLA services we provide.

2.22 This is why, in the letter from Clive Selley to Melanie Dawes (dated 26 June 2020) making the commitment to build to 3.2m homes in Area 3, we set out our assumptions about the approach Ofcom would take to regulation after 2026. Specifically, we assumed:

a) Ofcom would provide clarity on its longer-term approach to regulation where we noted Ofcom's statements that it would expect the approach to WLA pricing proposed in Area 2 from 2021 to endure for at least 10 years; and
b) Ofcom would honour the fair bet.

2.23 Again, our position here is the same as our position in commenting on Ofcom's earlier proposals for regulating prices of WLA services within Area 2. We need assurance that the assumptions we are making in taking the decision to invest across the UK at scale are reasonable.

The assurances we are seeking

(a) What is needed on clarity of future regulation?

2.24 The risk of uncertain future regulatory approaches and the challenges this creates in making investment decisions means there are benefits in Ofcom signalling there will be an extended period of stability in its approach to regulating WLA services. In Area 2, Ofcom has given such signals to investors in its briefings around its WFTMR proposals.

2.25 Ofcom positions its Area 3 proposals for regulation of prices of current copper/FTTC anchor prices from 2021 as part of a "RAB approach" where cost recovery for FTTP is spread across a wider range of access services. As such, Ofcom's proposals to allow the price of regulated anchors to stay flat in real terms in 2021 are presented as providing a mechanism for funding otherwise unprofitable incremental investment in FTTP. The suggestion is that the decision about whether copper/FTTC prices should continue to be held flat in real terms or to stay flat in nominal terms after 2026 would be based on a revised view of the funding 'shortfall' that would likely be faced. The implies the shortfall would be recalculated ahead of the 2026 decision using actual information on incurred deployment costs and provisioning costs and revised forecasts of opex, volumes and ARPU uplift. The regulatory approach post 2026 is therefore uncertain in Area 3.

2.26 In our assessment of Ofcom's modelling approach, we conclude cost recovery over 20 years is likely to require at least two periods of CPI indexation to be applied to copper/FTTC anchor prices. This could, in itself, support Ofcom signalling the proposed 2021 approach will endure in Area 3 for at least a further five years from 2026.

2.27 However, we also believe there are a broader set of policy reasons to support Ofcom signalling a continuation of CPI indexation across this longer period:

a) We believe Ofcom is understating the scope for investment by other FTTP network builders in Area 3, noting – in particular - the statements such builders have made to Ofcom in response to the January 2020 WFTMR consultation on this point. This supports Ofcom adopting the same approach to pricing within Area 3 as proposed within Area 2 where Ofcom is explicitly aiming to promote entry;
b) Wholesale access charges to date have been geographically averaged across the UK. Having the same level of safeguard anchor pricing across the UK avoids creating geographic differences for the first time;
c) Allowing prices to stay flat in real terms provides price stability for customers during a period of network transformation, migration of lines and retirement of existing assets when unit costs of provision of existing services would otherwise be volatile; and
d) Adopting real terms flat pricing will provide a better opportunity for us to recover the ongoing costs of the legacy copper/FTTC assets as services migrate to fibre networks ahead of legacy network retirement and

avoid leaving us facing stranded costs. This in turn provides ongoing incentives for us to invest in the new fibre network and drive migration onto the new platform.

2.28 We would therefore suggest that Ofcom signal its expectation that CPI indexation of legacy anchor services will apply after 2026.

(b) What is required to honour the fair bet?

2.29 The fair bet principle is important in that, if assessed and applied in an appropriate way, it addresses the challenge of contemplating how future regulation might impact investment returns. The principle is that future regulation will not be applied in a way that will change the terms on which the original decision to invest was made. So if the probability-weighted expected outcome of the investment case was based on the assumption that certain upside outcomes were attainable, then future regulation should not be set in a way that removes the possibility of such outcomes.

2.30 Our understanding is that Ofcom accepts this principle. In this consultation, Ofcom explicitly states that it would approach setting any charge controls applied after 2026 "giving regard to allowing the fair bet on investments". But while this general statement of principle is welcome, more certainty is needed to understand what this might mean in practice: i.e. how will this shape future decision-making on whether, when and how to regulate our pricing for WLA services.

2.31 Specifically, as the fair bet principle is based around ensuring future regulatory decisions are consistent with the terms of the investment 'bet' at the time it was placed, we are asking Ofcom to explain how it will give weight to those terms in future pricing decisions such that our investor can be confident that the expectation that it will earn at least ✂% is based on sound assumptions about the attainability of upside outcomes. BT Group has been discussing the detail of its assessment of what is required to provide clarity around Ofcom's approach and assurance that the terms of the fair bet will be honoured.

Why a 'RAB approach' provides insufficient support for the investment case

2.32 In contrast with the above, we are concerned that Ofcom envisages a longer-term policy approach within Area 3 that could adjust WLA pricing at each 5-year review point and will not provide an opportunity to earn returns that are consistent with the investment bet we are looking to place. Specifically:

a) Ofcom positions its Area 3 policy approach as representing a "RAB approach" suggesting something akin to approaches adopted in utility sectors with monopoly suppliers of services, where the costs of new capital investments are socialised and recovered across all customers, which is expected to endure into future review periods.

b) Consistent with this, Ofcom presents Area 3 postcode sectors as representing a wide area of c9m homes where there may be only limited competitive entry and volume risk over the long run.

c) In suggesting that it would "re-base" its assessments of long-term cost recovery requirements at each 5-year review point, Ofcom's approach could amount to a series of adjustments to Area 3 pricing designed to deliver cost recovery over 20 years. This could then tend towards a form of "rate of return" regulation. That is, at each review point, Ofcom appears to be suggesting it would recalculate the 'shortfall' calculation based on actual data to date and revised forecasts, and reassess how much had been allowed to fund this 'shortfall' from the pricing approach adopted in earlier review periods. This could mean that the allowed prices in each future review are required to move up or down so that they remain consistent with an expectation of cost recovery by year 20 reflecting outputs of Ofcom's "re-based" model. For the final review period in 2036 any pricing could be defined by actual cost, volume and pricing information over the prior 15 years and re-set to ensure no more than a return equal to WACC is achieved on the 3.2m investment by year 20.

d) While we acknowledge Ofcom suggests its approach would incentivise efficiency and have regard to the fair bet, it is not clear how this would be applied within the envisaged model if all parameters are "re-based". For instance, all capital expenditure incurred in building the network will necessarily be incurred within the first 5 years (i.e. in line with the commitment to build to 3.2m homes by March 2026) and additional capital incurred in provisioning FTTP lines once the network is built will be incurred over the first 5-10 years. If Ofcom plans to "re-base" shortfall calculations at each 5-year review point, then any efficiencies achieved in deploying or provisioning the network at lower cost that is envisaged in Ofcom's 2020 modelling forecast would simply be absorbed into a lower shortfall calculation at future review points and, therefore, lower revenue requirements and lower regulated charges. It is also not clear how such an approach would allow for the risks and uncertainties faced at the point the commitment was made.

2.33 The approach Ofcom envisages may, therefore, remove opportunities for us to earn any upside on our investments in Area 3, compromising the fairness of the risky bet that our investors would be placing.

2.34 Furthermore, the forecast "RAB approach" would only support long-term funding under an assumption that we would face largely stable and predictable customer volumes within Area 3.

2.35 In the January 2020 consultation, Ofcom provisionally determined that Openreach holds SMP in Wholesale Local Access across all Area 3 postcode sectors and suggested that there was only limited scope for alternative network build to emerge in Area 3 postcode sectors relative to Area 2 postcode sectors where it had identified that there was either already alternative coverage or there were specific plans for other network builders to invest. Ofcom therefore categorised the Area 2 postcodes as 'potentially competitive' and Area 3 postcodes as 'non-competitive'. But the judgement about whether postcode sectors fell into Area 3 was driven by the existence or otherwise of specific build plans, not by whether any alternative build may be viable or desirable over the next 5 years. We note that a number of network builders responded to Ofcom's January consultation by suggesting there was scope for viable commercial build – e.g. City Fibre suggested they could see scope to build to around 3m THP within defined Area 3 postcodes. This aligns with our own assessment that many of the postcode sectors defined as falling within Area 3 will look similar to Area 2 sectors in terms of supply and demand conditions or at least not so dissimilar as to fundamentally shift the commercial case to build.

2.36 Ofcom acknowledges that there is some competitive overbuild already within Area 3 – e.g. by Virgin, albeit below the coverage thresholds Ofcom has set - and that there is scope for further build to take place. Indeed, Ofcom sees merit in adopting the Area 2 pricing remedies and introducing restrictions on geographic pricing within area 3 as these remedies could facilitate a greater level of competitive build in Area 3. Furthermore, other network builders will be active in bidding for any form of public subsidy available within Area 3 to support coverage. This all points towards the provision of access lines within Area 3 at least being contestable over the next 5-10 years and potentially for parts of Area 3 to become effectively competitive.

2.37 As we noted in our response to the January consultation, Ofcom's analysis in the January 2020 consultation has not established that Area 3 is 'never to be competitive' and, in any event, we would expect Ofcom would have to reassess the extent of competitive build that has emerged and may emerge in the future in Area 3 as part of all future market reviews it conducts. We acknowledge that Ofcom's outlook may be that competitive build in Area 3 is less likely than in Area 2 and that this is driving a policy concern that there may be lower commercial incentives for Openreach to deploy FTTP in these postcode sectors. But the commitment we are making about the level of build we will complete within today's list of defined Area 3 postcodes provides an assurance to address that policy concern and, as such, reduces the relevance of Ofcom's assessment about the scope for competition to emerge in the future. It is clearly possible that competition will emerge and we would note that Ofcom has established regulation of passive services in both Area 2 and Area 3 to facilitate this.

2.38 But in noting the possibility that competitive network build could occur in Area 3, Ofcom should recognise the risks in any longer-term regulatory funding model. In our view, there is scope for both commercially-driven entry by access networks in Area 3 postcode sectors and for competition for publicly subsidised build (which will then support additional commercial build around publicly subsidised build). Given our view that future Openreach customer volumes within Area 3 are uncertain, the indication that Ofcom will use a forecast "RAB approach" in subsequent pricing reviews provides limited comfort about cost recovery and does not eliminate or significantly reduce risks as we see them.

2.39 In particular, if, contrary to Ofcom's expectations at this point, Openreach Area 3 volumes fall, then under the "RAB approach" prices would need to rise for all remaining customers in order to fund the shortfall. But it is not clear that in such circumstances prices could be raised: we may either expect to face commercial constraints given the risk that price rises for remaining Area 3 customers may simply trigger additional line loss to new builders; or allowing such price rises may become less palatable from a regulatory perspective leading Ofcom to depart from the "RAB approach" altogether if there is the emergence of competition in Area 3 where previously none had been considered viable. Either way, any indicative statements Ofcom make about its intentions to adopt a "RAB approach" are insufficient to offset the risks of competitive line loss within Area 3. This all points back towards the importance of Ofcom providing clarity on how it would approach the fair bet at future reviews.

2.40 We would also note that it is not necessary for Ofcom to reach a firm conclusion at this point on whether Area 3 will or will not be competitive at any future point. The proposed safeguard caps on current anchor services and the introduction of a new FTTP anchor will have the effect of protecting consumers from price rises for existing access services during a period of network transformation and we are not suggesting Ofcom signals it would never intervene to constrain prices further in the future; merely that if it does so, it would honour the fair bet.

Restrictions on our commercial flexibility to supply access services within Area 3 are unnecessary

2.41 We do not agree with Ofcom's proposals to use ex ante remedies to restrict our ability to introduce geographic discounting of prices within Area 3 in for the same reasons we do not agree with the proposals in Area 2 – i.e. that they are unnecessary to address the risk Ofcom has identified.

2.42 We welcome Ofcom's acknowledgment that other network builders have ambitions to deploy FTTP within Area 3 over the next five years and that there is already some alternative network build within Area 3 postcode sectors. This is more closely aligned with our own assessment of the scope for alternative network build and view that there is potential for rival deployment in Area 3 postcode sectors as well as Area 2 postcode sectors.

However, we do not accept that there is a material risk that we would target geographic discounts in an unfair way when selling our FTTP access services as part of a strategy to deter these other network builders.

2.43 Ofcom is proposing to regulate anchor services in Area 3 by reference to today's price levels which are geographically averaged. To the extent that we look to vary pricing across different parts of Area 3, we would have to move anchor pricing below the regulated price ceilings and/or have different prices for higher bandwidth services. Such pricing may reflect localised cost differences or reflect differences in the commercial strategies that we believe would support adoption of the new platform in different areas – ✂. We also note that the restriction on geographic variation in pricing within Area 3 and the need to seek consent would apply in all cases, including where we may introduce geographic variations in pricing in a part of Area 3 where no alternative build has occurred or is planned and/or in areas where Virgin Media has established network. The restriction does not therefore seem proportionate to the concern that Ofcom has raised about the impact on new network builders.

2.44 Furthermore, where we are competing head to head with new network builders within Area 3, we would expect them to consider a range of commercial options to support their investment case and drive total volumes and ARPU growth and this may include introducing geographical variability in pricing across their network. In those areas, we do not want to have to compete on an unlevel playing field. To the extent that Ofcom's concern is that we may put anti-competitive pricing into certain areas with the aim of restricting competition, this would be captured by competition law.

2.45 We acknowledge that geographic discounting may be permitted within Area 3, so long as we seek and gain consent. But, consistent with our comments in the January consultation in relation to the Area 2 proposals, it is not clear what factors Ofcom would accept as relevant in considering whether to grant such consent. Our concern is therefore that the remedy is applied in a rigid way that reduces our competitiveness. At the very least, the operational process of having to seek and obtain consent reduces our commercial agility.

2.46 We therefore propose the same approach we are pushing for within Area 2: at a minimum, Ofcom amends its proposals to limit the proposed *ex ante* restrictions on geographic discounts to Openreach's provision of FTTC access rental services only. However, to the extent Ofcom maintains its position we would want to see more detailed guidance signalling the circumstances under which geographic variations would not raise concerns. Finally, in line with our response to Area 2, it is important that Ofcom confirms that we would not need to seek consent on any existing pricing within Area 3 that may include geographical variations in price.

3. Charge control design and implementation of forecast RAB approach with BT Commitment

Question 4.1: Do you agree with our proposals for basket design and implementation of a forecast-RAB?

Basket design

3.1 The basket design proposal in Area 3 is consistent with Ofcom's intention to align the proposed regulation of prices in Area 2 and Area 3. We agree that price regulation should be aligned between Area 2 and Area 3 and on that basis we agree with the proposals for:

a) A single product charge control for MPF rentals and GEA FTTC 40/10 rentals only; and

b) A single product charge control for GEA FTTP 40/10 rentals in Area 3 (where no copper-based network access is available).

<u>Single product charge control for MPF rentals and GEA FTTC 40/10 rentals only</u>

3.2 For a number of services, especially single item GEA services, the price ceiling in the first year is prescribed in the conditions. That means if the effective date of the price change is delayed past April 2021 there is no way to make good the foregone revenue due to the delay. In section 6 below we ask that Ofcom publish a draft final statement before the end of Feb 2021 and waive notification obligations for first year price changes in order to ensure Openreach can notify price changes by 1 April 2021.

3.3 If Ofcom were not to address this issue as we propose, we consider Ofcom should change the condition for the relevant services such that, instead of a fixed ceiling in the first year, it allows for an average price over the first year period. This average price approach has already been adopted by Ofcom for MPF SML1 rental prices so we see no reason why a consistent approach shouldn't be adopted for services where the price ceiling in the first year is prescribed, and especially for single item GEA services where the impact could be significant. Such an approach would ensure the price changes are implemented as Ofcom propose and intend.

<u>Single product charge control for GEA FTTP 40/10 rentals in Area 3</u>

3.4 Ofcom propose to align Area 2 and Area 3 obligations. We commented on Ofcom's proposed basket design for Area 2 in response to the January consultation and we have no further comment to make in relation to the proposed price regulation for GEA FTTP 40/10 rentals.

Compliance with build commitment

<u>Data for monitoring compliance with the commitment</u>

3.5 We agree that sharing data with Ofcom annually to allow Ofcom to monitor progress of the 3.2m build commitment is appropriate and proportionate. Our views on the specific requirements proposed by Ofcom is contained in the BT Group response to the proposed Regulatory Reporting requirement. Whilst we are comfortable to share the proposed monitoring data with Ofcom privately we consider it would be inappropriate to publish this detail more widely as it would provide Openreach's competitors in Area 3 with an unfair advantage and would in any case undermine Ofcom's objective of encouraging entry.

3.6 In the consultation, Ofcom acknowledges that there is some competitive overbuild already within Area 3 – e.g. by Virgin, albeit below the coverage thresholds Ofcom has set - and that there is scope for further build to take place. Indeed, Ofcom sees merit in adopting the Area 2 pricing remedies and introducing restrictions on geographic pricing within Area 3 insofar as these facilitate a greater level of competitive build in Area 3. Furthermore, other network builders will be active in bidding for any form of public subsidy available within Area 3 to support coverage.

3.7 The private information that Ofcom requires for monitoring purposes is commercially sensitive as it would provide competitors in Area 3 with insight into Openreach's costs to the extent that it might risk distorting competition. Ofcom does not explain in the consultation how it would assess the cost and benefits of public disclosure of the highly sensitive information. However, in the context of actual and potential entry in Area 3 it is hard to imagine how any apparent benefits, through increased transparency with external stakeholders, could outweigh the potential damage to competition and Openreach's interests.

3.8 On that basis, should Ofcom assess that any of this highly commercial sensitive information should made public, we consider it should layout its assessment criteria and process in detail and provide stakeholders with an opportunity to consider how it has conducted that assessment prior to issuing its final statement.

Re-opening the charge control

3.9 We are committed to meeting the build commitment and, in common with Ofcom, we fully expect Openreach to meet its commitment to deploy fibre to 3.2m premises in Area 3 by 2025/26.

3.10 Ofcom states that "*In the event that it became clear that BT was not making progress in meeting its build commitment, we would look to re-open the charge control to avoid harm to customers (as a result of prices being above cost).*"[4] Openreach acknowledges that Ofcom propose to extend Area 2 price regulation into Area 3 based on Openreach's 3.2m build commitment. In that context it seems unsurprising that Ofcom would consider intervening in a scenario where Openreach was not making progress in meeting the commitment.

3.11 Ofcom singles out for comment how they might adjust prices in such a scenario to reflect the notional benefit Openreach gain during the charge control period due to their treatment of accelerated depreciation in their pricing proposals for Area 3. Ofcom acknowledges that the allowance for accelerated depreciation was not included in their published analysis, so to some degree this is a moot point. But even if Ofcom had included an allowance in their assessment, it would have increased the cost-based baseline against which it compared the value of indexation. In this context, its treatment of other parameters and assumptions e.g. efficiency, volumes and line loss, RAV adjustment, holding losses and holding gains might on the same basis be relevant considerations for assessing how it might respond or intervene. Essentially, it is hard to understand why any assessment that reviewed only one parameter or assumption in Ofcom's estimate of the cost-based base line would be proportionate or sufficient.

3.12 Further, Ofcom's overall assessment of the appropriateness of extending Area 2 pricing to Area 3 is a comparison of the value of indexation with the FTTP shortfall. It is entirely plausible, given the uncertainties over cost of supply for FTTP, that Ofcom's assumptions in relation to build costs, connection costs, net cost

[4] Para 4.13

savings or the FTTP premium turns out to be incorrect and that Openreach could suffer a level of shortfall consistent with Ofcom's ranges even if it has not built out to 3.2m premises. This appears to be a relevant factor that Ofcom might also need to consider.

3.13 It would be premature to comment in any detail as to what factors would be relevant for Ofcom to take into account to assess the most appropriate and proportionate course of action as it will be very dependent on the precise nature of the failure to meet the commitment.

Fit with public subsidy schemes

3.14 We agree in principle that Openreach's fibre build that has been paid (or will be paid) through a subsidy should not contribute to meeting the BT Commitment.

4. Comments on Ofcom's cost modelling

Key points

4.1 In Section 2, we set out concerns with Ofcom's suggestion that it could apply a "RAB approach" over the longer-term in Area 3. Nevertheless, the cost modelling exercise Ofcom sets out in this consultation is helpful in assessing the longer-term commercial and regulatory challenges. We note that the primary purpose of the cost modelling exercise in this consultation is to consider whether the firm proposals relating to WLA pricing in the period from 2021 to 2026 are reasonable in providing an "expectation of cost recovery". We believe the broad modelling framework Ofcom lays out in the consultation provides a reasonable basis to make this assessment. Specifically:

a) We agree in principle that the design of the CPI-X model and the FTTP bottom up model are appropriate to estimate the cost of supply in Area 3 in a scenario where Openreach build out FTTP to 3.2m homes passed;

b) We agree in principle with the design of the Shortfall model, which estimates the shortfall that would likely arise due to the incremental 3.2m investment; and

c) We agree in principle with the design of the Cash Flow model, which estimates the likely incremental value of indexation.

4.2 The outputs of this modelling exercise are dependent on a wide range of assumptions relating to, among other things, future costs of building the FTTP network and supplying access services, the volumes that will remain on Openreach's network over the longer-term and customers' willingness to pay a premium for higher bandwidth FTTP access services. Ofcom's assumptions and projections will clearly not always align with our own. But notwithstanding these differences in judgements about the future, it is apparent that the consultation ranges for the values of the shortfall and incremental revenue that indexation could generate over 20 years are misleading on Ofcom's own terms. Specifically, we have identified five modelling calculation errors / inconsistencies between the way the models have been set up and the way Ofcom describes its intentions in the consultation (discussed with Ofcom on 26 August 2020). These errors / inconsistencies are outlined in more detail below.

4.3 Ofcom should update its analysis to correct for these errors / inconsistencies. Once it has done so then it becomes clear that an expectation of cost recovery over 20 years is more consistent with indexing existing WLA anchor prices to CPI for two control periods from 2021.

4.4 Moreover, there are then additional adjustments we believe Ofcom might make to its assumptions that would better reflect the expected shortfall and additional revenues that would be most likely in Area 3. Adjusting its assumptions to partially or wholly reflect Openreach's view on these matters further supports a conclusion that it would be reasonable that at least two periods of indexation should apply to legacy services in Area 3. These additional reasonable adjustments are outlined in more detail below.

4.5 On the basis of the above, we believe Ofcom's modelling should support it signalling its expectation that WLA anchor prices in Area 3 will be regulated at CPI-0% for at least two 5-year review periods and it would be reasonable to treat Area 3 in the same way as Area 2.

The overall evaluation approach

4.6 A convenient way to describe the assessment Ofcom perform is as follows:

a) Define the 'Total Cost of Area 3 Supply' over a 20-year period allowing for a 3.2m THP level of fibre build and migration from copper to fibre.

b) Consider options for how prices for all Area 3 access services could be set to ensure the total costs of Area 3 supply will be recovered over 20 years and what the role of regulation in constraining such prices should be.

4.7 In order to make this assessment it mainly uses four models:

a) FTTP bottom up build model – using various sources of data, including Openreach models, the key outputs are estimates of the build and connection cost for the committed 3.2m FTTP build in Area 3. These estimates are used as cost inputs to the Shortfall model.

b) The Shortfall model – this estimates the shortfall that arises due to the 3.2m FTTP investment. That estimate is the net of:

(i) Cost of build and connections based on the outputs of the FTTP bottom up model – this is a new estimate;

(ii) Less incremental FTTP revenues – specific incremental ARPU above legacy ARPU assumptions are made;

(iii) Less net cost savings due to FTTP (difference in repair costs between legacy services and FTTP services and avoided copper accommodation and FTTC cabinet operating costs). These estimates are the same as the January consultation

c) CPI-X model – this is a model that estimates the future cost of the legacy services in the absence of the 3.2m build commitment. The key output is the price (X) that would apply to copper and FTTC services in the absence of the build commitment.

d) The Cash Flow model – this estimates the value of indexation over and above a legacy services cost-base baseline i.e. the most likely price level absent a commitment to build. The cost-based baseline is based on the X estimated in the CPI-X model.

4.8 In principle we support this evaluation approach.

Correction of errors & inconsistencies

4.9 At a meeting on 26 August between Ofcom and Openreach, we highlighted a number of anomalies in Ofcom's modelling. Ofcom agreed that the published estimates in the consultation contained a number of errors / inconsistencies which Ofcom would likely seek to address at final statement. These errors are as follows:

a) **Item #1 - FTTP build and connections costs**: Our planned commercial build programme for Area 3 will cover a mixture of post codes with low and high build costs For that reason, we agree with Ofcom's stated approach to estimating average build and connection costs for the 3.2m committed build is "*to estimate …. build and connection costs for 7.0m of the 8.8m Area 3 premises … scaling this down to 3.2m on a pro-rata* *basis*"[5] is a reasonable approach. However, Ofcom's Shortfall model instead calculates the cost of the 3.2m footprint assuming roll-out is done in order of the cheapest tranches. The effect of this is that Ofcom's model has lower capital costs per premises than intended. On the 26 August call Ofcom agreed:

(i) that the average FTTP build cost used in the modelling should have aligned to the range in the consultation of £370-£490 per home passed (mid-point of £430) rather than the range used in the model of £315-£390 (mid-point £353). Correcting for this error has the effect of increasing the shortfall by c£230m.

(ii) that the average FTTP provision cost used in the modelling should have aligned to figure quoted in the consultation of £280 per home passed rather than the figure used in the model of £250. Correcting for this error has the effect of increasing the shortfall by c£60m.

b) **Item #2 - The X in the CPI-X model**: We agree that Ofcom should use discounted prices to estimate the proposed X for FTTC in the CPI-X model. In its clarification note of 11 September Ofcom explained that the X of -2.75% used in the published CPI-X model to estimate the cost-based baseline should have been -3.75%. Correcting for this error has the effect of increasing the incremental revenue from indexation by c£150m.

c) **Item #3 - Accelerated depreciation**: We agree in principle that depreciation for copper assets stranded by the 3.2m FTTP build should be brought forward to the charge control period. In its clarification note of 11 September Ofcom explained that the impact of the additional £130m of cost recovery through accelerated depreciation was not included in the estimate of costs used in the consultation. Following Ofcom's methodology used for accelerating depreciation in CPI-X model provided in the January consultation, we calculate correcting for this error has the effect of reducing the X by +1.00% over the next 5 years and would reduce the incremental revenue from indexation by c£150m.

d) **Item #4 – Line loss:** In its clarification note of 11 September explained that their estimate of additional revenue due to indexed legacy revenue assumed that Openreach would retain all lines in Area 3 for the whole 20-year period. Uncertainty over the precise level of volumes that we will retain, given the scope for competitor overbuild is a key reason why we do not think a rigidly applied "RAB approach" can work to underpin cost recovery over the longer-term. In any case, it is implausible that Openreach's volumes will remain stable across Area 3 over the next 20 years and it is not clear to us that this is what Ofcom actually expects to happen. Firstly, it is not reasonable to assume that Openreach will be the only supplier in public subsidy areas. The bid process is competitive and Openreach has not won (or should not be expected to win in future) all of these bids. Secondly, Ofcom acknowledge that Alt Nets have announced plans to "overbuild" gigabit capable networks in parts of Area 3. Further, we anticipate material line loss due to multi-line decline. For these reasons, and assuming even a moderate level of line loss to reflect reductions in second lines, other builders winning some public subsidy contracts and some degree of commercial competitor overbuild will have a significant impact on Ofcom's cost recovery projections. Accounting for a more reasonable expectation of line loss has the effect of reducing the incremental revenue as a result of indexation by c£✂ (for the 5-year indexation scenario) to c£✂ (for the 10-year indexation scenario).

e) **Item #5 - Inconsistent FTTP volumes**: There is a significant inconsistency between the FTTP build volumes assumed by Ofcom in its estimate of the shortfall vs its estimate of the additional revenue resulting

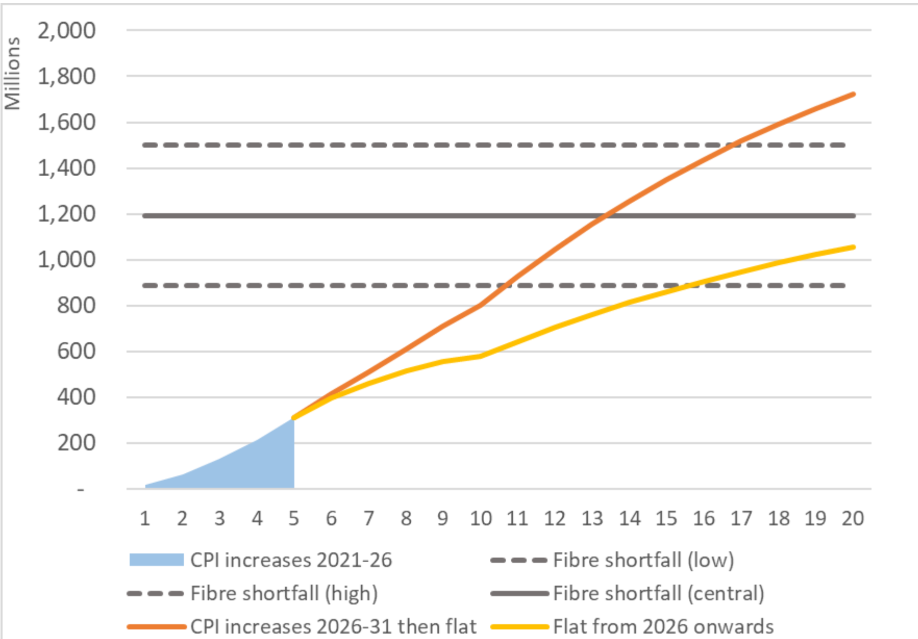
[5] Para A2.12

from the premium that would result above legacy services in the Cash Flow model. To estimate the shortfall the build and connection costs are based on 3.2m THP. To estimate the incremental revenue from the FTTP premium Ofcom assumes, up to 2031, that the relevant volumes are 4.8m THP and, from 2031, 8.8m THP. We do not believe it is reasonable to account for the additional revenue from 50% more FTTP build ahead of 2025/26 (to capture publicly funded build) without also accounting for the additional consequential build costs, or to account for the implicit additional revenue beyond 2025/26 to reach full coverage by 2030/31 (and allow full copper retirement by 2031) without accounting for the additional build costs that implies. We have been unable to confirm with Ofcom if there is some rational basis for the inconsistency in assumed volumes when estimating the shortfall value and relevant incremental FTTP value. The focus of Ofcom's assessment is the extent to which prices for all Area 3 access services could be set to ensure the total costs of Area 3 supply for 3.2m FTTP committed build will be recovered over 20 years, it is more correct that both sides of the cost and revenue assessment of the 3.2m FTTP commitment is constrained to 3.2m FTTP lines. On that basis, constraining the estimate of the additional revenue resulting from the premium that would result above legacy services for the 3.2m FTTP build would reduce the incremental revenue from indexation services by c£100m.

4.10 In summary, these errors understate the NPV of the shortfall by c£300m and overstate the NPV of incremental revenues by c£450m. Cleary this has a significant impact on the assessment criteria Ofcom lay out in the consultation.

4.11 Figure A2.2 in the consultation shows the Fibre shortfall and additional revenue estimates over 20-year investment lifetime for central cost scenario (net present value, £m). This is re-presented below in Figure 2.

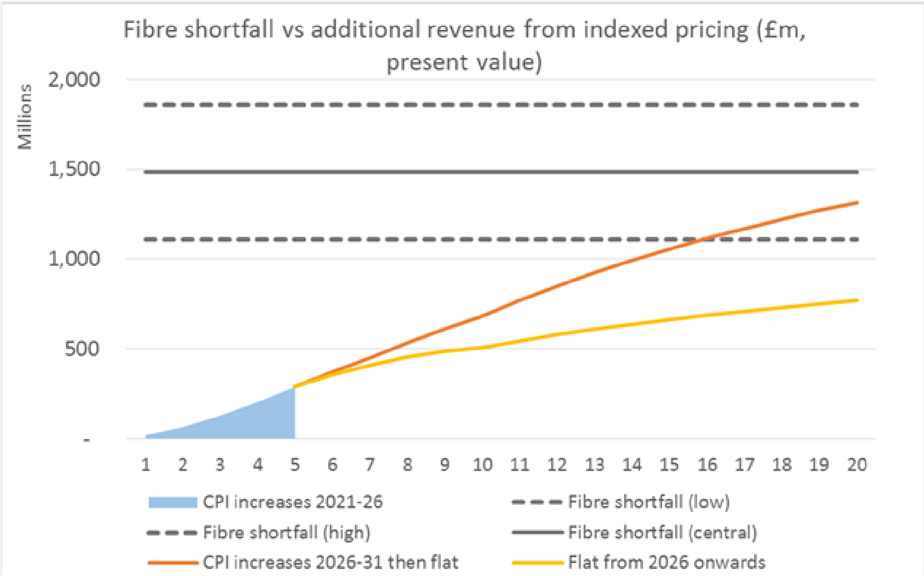
Figure 2: Uncorrected Fibre shortfall and additional revenue estimates over 20-year investment lifetime for central cost scenario (net present value, £m).



Source: Ofcom consultation as published

4.12 In Figure 3 below, we re-present the same graph but with the five errors corrected. This clearly shows that on Ofcom's own terms the shortfall is much higher and that intersection points much further in the future.

Figure 3: Corrected Fibre shortfall and additional revenue estimates over 20-year investment lifetime for central cost scenario (net present value, £m).



Source: Output from Ofcom models, adjusted by Openreach for the errors listed above

Additional reasonable adjustments

4.13 Effectively, the total cost of Area 3 supply is the sum of outputs from:

a) A model that estimates the ongoing costs of providing existing legacy services within Area 3 i.e. the CPI-X model

b) A model that can estimate the costs of operating and supplying service from a new FTTP network in Area 3 i.e. its FTTP cost model

Given the specific task in hand, these costs relate to a scenario where Openreach builds FTTP to 3.2m homes over the next 5 years i.e. consistent with the Openreach build commitment in Area 3.

<u>CPI-X model outputs</u>

4.14 The CPI-X model is a national model, not an Area 3 specific model. It produces an 'average cost of supply' to all of the UK and is therefore, on Ofcom's terms and absent more granular geographic data, a reasonable estimate of the costs of supply for legacy services within Area 3.

4.15 On that basis, the key comments we have relate to the specific methodology applied to estimate costs:

a) **Accelerated depreciation**: We agree that Ofcom should accelerate depreciation to account for the fact that Openreach will build FTTP to 3.2m homes in Area 3 by 2025/26 and therefore need to recover the cost of legacy assets used to serve those homes by 2025/26. However, the mechanism Ofcom used to take accelerated depreciation into account in the January consultation modelling would, if applied here to the £130m, actually result in recovery of £88m rather than £130m. This is because the X follows a glide path, but these costs are evenly spread (in present value terms). The shortfall is greatest in year 1, reducing to year 5. If Ofcom adopted the same approach to the £130m accelerated depreciation, as it did in the January consultation, we estimate that the X would change by +1.00% (make it less negative by 1.00%). That +1.00% adjustment (consistent with its January consultation approach) would be an error, all other things equal. An adjustment of +1.50% would more properly be required to account for glide path effects and ensure full cost recovery i.e. the X should be -2.25%, all other things equal.

b) **RAV adjustment**: as per our May 2020 consultation response we propose a superior method of estimating the RAV adjustment over the WFTMR period. We calculate this has the effect of reducing the X (i.e. make it less negative) by 0.75%.

c) **Holding Gains / Holding Losses**: as per our May 2020 consultation response we propose a correction to Ofcom's calculations in estimating the NRC over the WFTMR period. Correcting this has the effect of reducing the X (i.e. make it less negative) by 0.50%.

d) **Opex Efficiency**: In Ofcom's Area 3 analysis the opex efficiency applied by Ofcom compounds the assumed 4.8% efficiency year on year for 20 years. Ofcom's estimate of costs is very sensitive to the level of opex efficiency assumed, each 1% efficiency reduces NPV of additional indexation revenue by c£150m. Ofcom's estimated opex efficiency amounts to a forecast total real operating unit cost reduction of 74% over that period. This is not reasonable.

(i) We understand the 4.8% efficiency assumption is unchanged since the January consultation. We argued in our response to the January consultation that the relevant historic and forecast data suggested a much lower level of opex efficiency would be achievable over the charge control period (the medium term). We still consider this is the case and that Ofcom's estimate should be adjusted down below the consultation range of 3.5% to 6.5%.

(ii) We recognise that high efficiencies might arguably be sometimes achievable in the short to medium term e.g. there might be significant shorter-term catch-up gains to be had above the longer term productivity trend. But in the longer term the level of efficiency achieved will tend to converge on longer term productivity trends. For example, for the purposes of its long-term projections, in 2018, the Office for Budget Responsibility "*assumed that productivity growth would rise beyond the medium term to reach 2.0 per cent a year from 2030-31 onwards*".[6,7]

(iii) On the basis of the above, we still consider that Ofcom must reduce its medium-term efficiency assumption to reflect historic unit cost data and medium term Openreach forecasts. In the longer terms, Ofcom should use an assumption that more closely reflects long term productivity trends. It should be no more than the midpoint we proposed in response to the January consultation i.e. of 2%.

FTTP cost model outputs:

[6] https://obr.uk/economy_categories/productivity/

[7] Measures of telecoms specific productivity should be discounted as they can be distorted by changes in quality. First, it is challenging to measure quality, as indicated by the recent significant revisions to ONS "like with like" telecoms comparisons over time. And second, significant changes in quality at the sector level (e.g. improvements in broadband speeds) do not translate into realistic cost efficiencies that could be achieved at the firm level. These are more readily captured by economy wide metrics. ONS, July 2006, Improvements to the measurement of UK GDP: an update on progress.

4.16 Ofcom uses the capex and opex cash lines generated by its bottom up FTTP cost model under a specific Area 3 build scenario which are then adjusted to a 3.2m coverage. We agree in principle that the design of the FTTP bottom up model is a reasonable way of estimating the costs of building to 3.2m homes in Area 3. The two key outputs are (1) an estimated build cost per home past and (2) an estimated connection cost per home past which are then used by Ofcom to estimate the Shortfall.

4.17 Although the estimated build costs for Area 3 from our business case (£✂per home passed) is within Ofcom's (corrected) range; £370-£490 (mid-point of £430), the connections cost estimated by Ofcom is vastly understated. Ofcom's estimate is £280 per home connected compared to our business case estimate of £✂ per connection. Updating for our business case assumption would have the effect of increasing the shortfall by c£✂m.

<u>WACC</u>

4.18 AS BT Group set out in its response to the WFTMR consultation, fibre investment will have a magnified level of systematic risk because of: (i) the higher income elasticity of demand for FTTP relative to copper and FTTC assets; and (ii) the project involving a high level of operating leverage (the ratio of fixed costs to variable costs) relative to copper and FTTC assets. Both of these factors increase the systematic risk associated with FTTP and should be reflected in the FTTP asset beta in the calculation of WACC for fibre revenues and costs in Area 3. BT Group quantified the impact of higher operating leverage to estimate an FTTP WACC of ✂%. Using this higher level WACC, the difference between the fibre shortfall and the revenue uplift from indexation increases still further, by up to around £✂m.

5. Regulatory reporting requirements

Question 5.1: Do you agree with our proposals for reporting requirements?

5.1 The Regulatory Financial Statements (RFS) contain both Openreach and non-Openreach information and are produced by BT Group. BT's response to the Regulatory Reporting aspects of this consultation are covered in a separate BT Group response and there is no separate Openreach response to the proposals for reporting requirements.

5.2 In summary the key points are:

a) We support Ofcom's removal of providing information required for the post-build RAB approach in light of the BT Commitment to deploy FTTP to 3.2m homes in Area 3.

b) Whilst we can provide a note of the volumes of total homes passed in Area 3, we oppose the publishing of service level information for Area 2 and Area 3 separately:

(i) Ofcom's proposal is to split the costs based on take up volumes which would be commercially sensitive and result in no variance in unit cost between Area 2 and Area 3.

(ii) If we were to be able to report costs for Area 2 and Area 3 on a more accurate basis this would contain commercially sensitive information which our competitors could use to determine the viability of their own prospective investments.

c) We can provide privately to Ofcom key information on our FTTP rollout in Area 3:

(i) Information on the number of homes passed with FTTP by exchange area, and

(ii) A schedule detailing how much we have invested in FTTP networks in Area 2 and Area 3 per year.

6. Comments on the draft Legal Instruments

Key points

6.1 Ofcom propose separate conditions for Area 2 and Area 3 even though the obligations for services are the same. We would propose that there should be a single condition that covers both Area 2 and Area 3 services to reduce the risk of unintended inconsistent regulation.

6.2 Accommodating this proposal would result in a significant re-drafting of the legal instruments. Further, Openreach's proposed changes and correction of errors in its response to the January consultation are still to be addressed.

6.3 We would welcome the opportunity to review the Final legal instruments in advance of the final statement to help Ofcom ensure the changes have been made adequately. Further, seeing the final statement in advance would help ensure the practical activities required to change prices (which will take around one month) can be completed promptly and that we complete the required and necessary governance processes in time to implement price changes for the start of the charge control period.

6.4 For a number of services, especially single basket GEA services, the price ceiling in the first year is prescribed in the conditions. That means if the effective date of the price change is delayed past April 2021 there is no way to make good the foregone revenue due to the delay. We would ask that Ofcom publish a draft final statement before the end of Feb 2021 in order to ensure Openreach can notify price changes by 1 April 2021.

6.5 If the final statement is published later than November 2020, the proposed notification conditions (90 days) mean that Openreach will be unable to benefit from all of the price increases allowed by regulation, unless notice periods are waived. CPI indexation has been indicated by Ofcom since the consultation was published in January 2020 and so industry are already aware and should have planned for these price increases in April 2021; there is no added certainty for CPs and our proposed waiver would allow sufficient time for downstream providers to make necessary changes to their downstream products and services. On that basis, in the event that the statement is published after November 2020 we would ask Ofcom to waive notification periods to ensure the intended and expected prices can be implemented.

6.6 Lastly, we propose a number of detailed changes to the legal instrument in order to correct apparent errors and further, seek clarification from Ofcom as to the issues raised will be addressed in the Final Statement. We would welcome further discussion with Ofcom on these points.

Simplifying and removing duplication

6.7 The clarified legal instrument published on 28 February 2020 proposed a different suite of price regulation in Area 3 and Area 2. As a result there were two sets of proposed conditions published to reflect the two separate sets of obligations.

6.8 In the current Area 3 consultation, issued on 29 July 2020, Ofcom published a subset of modified conditions, predominately related to the Area 3 set of legal instruments previously published on 28 February 2020. Changes to those conditions are shown as 'marked up' with red font for insertions and strike through for deletions. This is a useful way to show changes for the purposes of this consultation.

6.9 Ofcom propose that most of the price regulation in Area 2 and Area 3 is aligned and the pricing conditions will be the same e.g. the application of indexation to MPF SML1 services. The presentation of the draft legal instrument alongside this consultation indicates that there will be separate conditions for Area 2 and Area 3 with a large element of duplication. We believe this is unnecessary duplication and risks errors and misalignment between the two sets of legal instruments. Further, in some cases Ofcom already adopts this approach and proposes that a single condition applies to Area 2 and Area 3.

6.10 On that basis, we request that for services where the proposed price regulation in Area 2 and Area 3 is the same, Ofcom is consistent and that single condition is used in the legal instruments published at Final Statement.

6.11 As an example, Condition 12B.1 as published in the February clarification states that it applies to both WLA Area 2 and WLA Area 3. The same approach could now be used for Condition 12B.2 (where the regulation of MPF SML1 rental was previously set out). As currently presented, Condition 12B.3 and Condition 12B.5 define the conditions for MPF SML1 in the same way as 12B.2. If Condition 12B.2 was instead indicated to cover WLA Area 3 neither Condition 12B.3 nor Condition 12B.5 would be required. Similar simplification can be made throughout Condition 12B and 12C and is set out in more detail in the "errors and clarifications" section below.

6.12 In the draft legal instruments in the January consultation and February clarification we identified a number of minor typing errors (for example missing brackets). Some of these unintended small errors have material effects e.g. one typing error unintentionally changed the charge control price ceilings. We recognise that streamlining the conditions as we propose above could introduce unintended errors, particularly in referencing. As changing the statement once published could be burdensome, especially if further consultation is required to correct anomalies, we would like to assist Ofcom in ensuring the legal instruments in the Final Statement are free of such issues. For that reason, we would appreciate the opportunity to review the legal instruments in advance of publication to mitigate the risk of unintended errors.

Publication of the Final Statement and implementation

6.13 In response to the January consultation we did not comment on the logistics of changing prices so that they would be effective from the first day of the charge control period. As this stage, prior to the extended timetable due to COVID-19, our understanding was that the Final Statement would be published with sufficient notice to allow implementation for 1 April 2021. At this stage, this is looking less likely and it is appropriate to discuss the details of implementation.

6.14 The governance process and systems updates required to revise prices is a non-trivial process and takes a good deal of time (one month minimum). For each Market Review since 2005, Openreach has had sight of the draft Final Statement issued by Ofcom to notify the European Commission. Those notifications allowed us to start the pricing implementation process around a month before those previous Final Statements came into effect. This in turn meant that we had been through the necessary governance processes and made the necessary system updates to revise prices by the time the Final Statement was published. Thereby in the past we have generally been able to implement the necessary price changes at the start of the control period even if the gap between the publication of the Final Statement and the start of the control period was short. Further, Ofcom has waived notification obligations in the past for first year price changes to ensure Openreach could compliantly change prices at the start date of the compliance period if the publication date of the statement is delayed.

6.15 We request that Ofcom waives the notification obligations for first year price changes and, in the event the UK's exit from the EU results in no notification of a Draft Statement to the European Commission, that Ofcom none the less publish a draft statement at least one month prior to publication of the Final Statement. If Ofcom assess publication of a Draft Statement is not possible, an alternative option could be delay the start date for the First Relevant period by a month to allow time for implementation, though this would require that some compliance formulae are amended. The proposed full first year impact of price change should be allowed over a truncated period e.g. if price increases cannot be implemented until one month after the proposed start date of the price control, the control formulas should allow Openreach to change the price so that it gets a full 12 month benefit in the first year of the charge control even though the price in the first year would only be effective for 11 months.

Errors and clarifications

6.16 Table 1 below contains proposed changes to the legal instrument in order to correct apparent errors and further, seeks clarification from Ofcom as to how the issues raised below will be addressed in the Final Statement.

Table 1 - Proposed changes to the legal instruments text and clarifications required

Reference in Document	**Clarification Required**
Schedule 1: SMP Conditions of original WFTMR consultation, Part 1: Application, Table 1	We presume that Ofcom will make changes to Table 1 as appropriate to refer to the correct conditions that apply to WLA Area 3 when the legal instruments are finalised. For example, Condition 4.5 should now be listed as applying, and if Ofcom agreed with our feedback, on simplifying the legal instrument conditions for 12B and 12C then the references for those conditions would also need to be updated.
Condition 12B.5	We believe this condition would be better expressed by using Condition 12B.3. As well as simplifying the condition, it also means that the Controlling Percentage will be calculated in the same way as all other charge controls, with the same formula to make use of the carrying forward of excess or deficiency. If Condition 12B.5 is included in the final version, we note that there is an unnecessary "+" symbol in the formula for the Fifth year.
Condition 12B.8	We believe that this condition could be removed, and Condition 12B.6 could be changed to apply to WLA Area 3 as well as WLA Area 2. This would result in a simpler legal instrument. This condition refers to calculating the average charge using the formula in Condition 12B.9. In the previous draft legal instruments Condition 12B.6 for WLA Area 2 referred to the weighted average price calculation on Condition 12B.10. If Condition 12B.8 is to remain as a standalone condition (and not be replaced by Condition 12B.6 indicating that is applies to WLA Area 3 as well) then we believe Condition 12B.8 and 12B.6 should refer to the same formulas and definitions for consistency.

Condition 12C.2	We believe this condition could be removed, and Condition 12C.1 could instead refer to WLA Area 3 as well as WLA Area 2. As it stands, the reference in Condition 12C2 (a) to Condition 12C.4(a) is appropriate, though Condition 12C.4 would need to be specified as referring to WLA Area 3 as well as WLA Area 2. Currently, this condition refers to price ceilings for the First Relevant year included in 12C.6 apart for the amended 12C.2(a) which refers to 12C.4. This whole condition – if not removed and replace by Condition 12C.1 – should refer to a single consistent condition.
Condition 12C.6	We believe that this condition could be removed, and Condition 12C.4 could be changed to apply to WLA Area 3 as well as WLA Area 2. This would result in a simpler legal instrument.
Condition 12C.9	We believe that this condition could be removed, and Condition 12C.8 could be changed to apply to WLA Area 3 as well as WLA Area 2. This would result in a simpler legal instrument.
Condition 12C.11 (draft legal instrument published with January 2020 consultation)	Condition 12C.11 could be removed if condition 12C.10 is indicated to refer to WLA Area 3 as well as WLA Area 2.
Condition 4	The draft legal instrument Conditions 4.1, 4.2, 4.4 and 4.7 are only indicated as applying in WLA Area 3. We presume this presentation is only for the purpose of the consultation on Area 3 and that that Ofcom still intends for these to also apply to all markets (for 4.1 and 4.2) and WLA Area 2 (for 4.4 and 4,7), as indicated in the draft legal instruments from the original consultation issued 8 January 2020. Consistent with that, we presume that the only change to Condition 4 will be to apply Condition 4.5 to WLA area 3 as well as WLA area 2 (in the initial consultation). We would ask that Ofcom confirm we have interpreted this correctly.