KCOM

Ofcom Consultation - Openreach Proposed FTTP Offer starting 1 October 2021

Non-Confidential Version

1. Introduction and Summary

1.1 KCOM Group Limited ('KCOM') welcomes the opportunity to provide comments on Ofcom's consultation on Openreach's proposed 'Equinox' FTTP offer.

1.2 On 1 July 2021, Openreach notified both Ofcom and its customer base of a proposed offer in relation to FTTP pricing ('the Equinox Offer').[1] Openreach is required to give 90 days' notice to Ofcom and its customers in relation to price changes, including offer pricing.

1.3 Ofcom published its consultation on the Equinox Offer on 6 August 2021, inviting respondents to comment on Ofcom's assessment of the offer.[2]

1.4 KCOM has significant concerns in relation to Ofcom's assessment of the Equinox Offer. **[Redacted]**. If Ofcom allows the Equinox Offer, it will materially affect the business case for KCOM's (and others') expansion plans. In turn, this will reduce the competitive pressure on Openreach to deliver its own roll-out targets, and risks delivery of Ofcom's overarching objectives, and delaying the Governments vision for a gigabit society.

1.5 We consider the Equinox Offer raises sufficient competition concerns to warrant Ofcom issuing a direction to prevent the offer. Our response sets out our concerns.

2. [Redacted]

3. Ofcom's WFTMR

3.1 At the conclusion of the WFTMR process in March 2021, Ofcom set out a regulatory regime to deliver the Government's strategic vision to bring gigabit-capable broadband to large parts of the UK. This had been done through a creative design of the framework, in a way that generated and harnessed a wave of competitive investment.

3.2 In KCOM's view, Ofcom could have gone further to facilitate the role that non-Openreach networks could play in delivering full-fibre broadband to parts of Area 3. However, Ofcom

[1] https://www.openreach.co.uk/cpportal/updates/briefings/ultrafast/nga201721

[2] Ofcom, Openreach Proposed FTTP Offer starting 1 October 2021 hereafter "Ofcom Equinox Consultation".

chose to rely instead on giving Openreach regulatory and commercial incentives to deploy its network throughout the UK. The presumption in the WFTMR is that due to its geographical footprint and market position, Openreach is likely to provide the majority of new, full-fibre infrastructure, and so it is vitally important that it is incentivised to do so quickly.

3.3 Ofcom's framework aims to incentivise widespread deployment from Openreach by making the threat of competitive investment credible and real. This was delivered through a combination of:

3.3.1 Mandating access to and tight price caps for wholesale inputs such as physical infrastructure, reducing the cost to alternative network providers (altnets) of establishing full fibre networks,

3.3.2 Looser price caps on wholesale products to improve the economics of full-fibre investment by both altnets and Openreach, and

3.3.3 A range of ex-ante prohibitions on Openreach that could disincentivise rival network build.

3.4 As such, the WFTMR does not mandate Openreach to deliver any particular FTTP deployment targets. Instead, it relies on Openreach being commercially incentivised to be ambitious with its full-fibre rollout, due to the risk it will lose market share as competitive altnet build accelerates.

3.5 The result of this was a framework broadly supported by players across the industry.

3.6 The certainty about the endurance of the regulatory incentives and facilitations in place – and an understanding that Ofcom would take all necessary steps to prevent any behaviour from Openreach that would even have the potential of deterring investment from alternative networks – was crucial to this perception.

3.7 This positive sentiment is a product of a number of decisions and statements made by Ofcom over the last 5 years following the Strategic Review of Digital Communications (DCR). It is a carefully-won battle, with a number of crucial building blocks. Ofcom will know how difficult it has been to get to this stage. And something so hard-won should not be so easily lost.

4. The risks to Ofcom's vision of competitive investment

4.1 Here we will set out why even minor changes to the overall balance between Openreach and rival networks has the risk of derailing Ofcom's vision and strategic objectives in WFTMR.

The Equinox offer risks significantly dulling investment incentives

4.2 Contrary to Ofcom's provisional findings in its consultation, the Equinox offer substantially alters the business case for rival network investment across the UK by changing the incentives for altnet entry and expansion. Ofcom's provisional decision to allow the Equinox offer, if confirmed, would risk undermining the careful balance struck in the WFTMR. City analysts have very clearly seen the Equinox offer for what it really is – "a "land grab" event for Openreach, making life harder for other infrastructure providers"[3]. It is surprising that Ofcom does not share this view.

4.2.1 All else equal, the Equinox offer is likely to result in ISPs taking up a greater proportion of Openreach services – at the expense of altnet network demand. The design of the discount could materially distort ISPs' choices and therefore competition in different areas. We set out the reasons for this in Section 5 below. The features of the scheme should be of concern to Ofcom; their ability to interact with one another should set alarm bells ringing for any competition authority.

4.2.2 While this may not have a significant impact on Openreach's full-fibre business case, it will materially affect the economics of altnet expansion in several geographical areas across the country – and particularly in Area 3 locations as the scheme will "likely make the business case for Rural AltNets harder"[4].

4.2.3 The incentives for altnets to quickly and nimbly invest in full-fibre networks ahead of demand materialising will be significantly dulled. Analysts expect that once an ISP has chosen to place its demand with the Openreach network, it is unlikely to "churn" away[5]. Existing altnets will be less likely to expand, and prospective new entrant networks will be deterred from committing to the market.

4.3 Openreach's deployment ambitions are just that – an ambition, not a legal commitment. In the absence of rival network build that has the risk of taking demand away from Openreach's legacy copper network, Openreach will have a weaker incentive to be ambitious in the pace of its full-fibre investment programme. It will likely find excuses to justify why its network is not yet reaching towns and villages across the country, and the Government's vision for a gigabit society will be pushed decades into the future, far behind

[3] Barclays, 1 July 2021: *BT Group PLC – Announcement of FTTP pricing, attempting "land grab"*
[4] ibid
[5] ibid

other countries in Europe and across the globe, or require a huge injection of public subsidy that has thus far been avoided.

4.4 [Redacted].

Ofcom's decision could kill nascent initiatives that could transform the wholesale access market

4.5 At present, ISPs contract separately with each wholesale network provider they connect to, meaning that there is an inbuilt incentive for them to choose Openreach's national network wherever possible, over alternative networks which operate in different areas. This acts as a deterrent for ISPs to choose altnets.

4.6 However, there are initiatives under consideration that would see the development of a new portal which could allow ISPs to transact with altnets via a single platform, materially reducing transaction costs, and therefore increasing the competitive pressure on Openreach to deliver capacity, high quality of service and to maintain its commitments to expand its FTTP network. The portal is therefore a crucial enabler of Ofcom's vision for the sector.

4.7 The Equinox offer, by incentivising ISPs to prefer Openreach's network over altnets, could mean the transformative potential of such an industry initiative would not be realised.

Ofcom's approach to assessing the Equinox offer will ring alarm bells for investors

4.8 Ofcom's seeming willingness to allow a significant change to the nature of competition in the market without much critical appraisal of the long-term strategic impacts of the offer, so soon after the conclusion of the WFTMR, will inevitably reduce investors' confidence in the endurance of the regime and the regulatory compact. This hit to investor confidence will not be easily recovered and the "wave" of competitive investment Ofcom had envisaged in the near-term will likely slow down materially.

4.9 Of greater concern is Ofcom's analytical framework for arriving at this decision. Ofcom's assessment that Equinox is unlikely to reduce demand for altnet services largely relies on Ofcom's analysis of ISP behaviour in a "plausible scenario" in which the demand for altnet services is largely unaffected[6]. However, a "plausible scenario" is not a sound basis for making a decision of this magnitude.

4.9.1 Ofcom effectively uses a set of "pass or fail" criteria for assessing the effect of Equinox on demand for altnets. Having concluded that the Order Mix Targets are

[6]Ofcom Equinox Consultation, para 2.48.

"unlikely" to deter use of altnets, it fails to consider two subsequent criteria, the effect of the Equinox offer on "nascent network competition" and whether or not the Equinox offer demonstrates "clear and demonstrable benefits" in its own right[7].

4.10 The result of this approach is that Ofcom has failed to carry out any analysis into the costs and benefits of the Equinox offer, because it deems at its first stage that the Equinox Offer is unlikely to deter use of altnets. While we disagree with Ofcom's conclusion in this first stage (see Section 5 below), we have a serious concern with Ofcom's analytical framework itself:

4.10.1 Even if it were a relatively unlikely scenario that Equinox deters demand for altnets, Ofcom should consider the trade-offs between the risk of deterred altnet investment and any potential benefits to consumers. Ofcom has not carried out any such analysis, and so there is no certainty the right balance[8] has been struck.

4.10.2 As such, there is a risk that Ofcom will permit a pricing change that does not deliver meaningful benefits to consumers that compensate for the risks of exposing them to significant costs (particularly over the longer-term), in the event that competitive altnet build is materially deterred, and Openreach's expansion is delayed.

4.11 In summary, when evaluating the Equinox Offer, Ofcom should take account of the material risks and consequences arising from alternative scenarios if those consequences are large, even if it considers those scenarios to be unlikely.

The damage may be irreversible – Ofcom should err on the side of caution

4.12 Ofcom suggests that it has tools available to it to address any concerns arising due to the Equinox Offer at a later date. However:

4.12.1 The damage that the Equinox offer will do to investor confidence and incentives will not be regained. Ofcom's decision here has much wider ramifications – it is a powerful signal about the direction of travel in the sector. It will concern potential investors – as they look beyond the Equinox offer – as it creates uncertainty about future changes that Ofcom may permit under an analytical framework that lacks

[7] Ofcom Equinox Consultation, para 2.39.

[8] Potential benefits of the Equinox offer may include that (some) customers will receive cheaper FTTP products (than they would absent the offer), and that customers will face lower charges in in the future should Openreach avoid the costs of running dual fibre and copper networks by bringing forward the "stop-sell" date for legacy broadband products. This would need to be balanced against the risk that other customers (e.g. in other geographical regions – likely to be the less competitive areas) get full-fibre broadband at a later date, because Openreach slows down (or simply doesn't deliver) its rollout of FTTP in the absence of competitive pressure.

robustness. As such, future entrants may be deterred, in the altnet sector and the UK telecoms market more broadly.

4.12.2 It is not sufficient for Ofcom to assume that investment in the sector will be plentiful so long as it allows altnets to achieve a positive NPV investment at Ofcom's estimate of BT's cost of capital (or close to it). Investors' horizons – and potential opportunities – extend beyond the UK telecoms market, spanning sectors and countries. Ofcom's decision here could risk UK telecoms going from one of the most attractive sectors for investors to one that is at the bottom of the pile. No amount of reactive course-correction in the future will restore this loss in confidence and positive sentiment towards the sector.

4.12.3 If alternative network investment is suppressed, Openreach's competitive full-fibre build may proceed at a slower pace – and many parts of the country will languish as uncontested monopolies forever.

5. The Equinox offer will chill rival network investment

5.1 Ofcom sets out in its consultation document why it does not consider the Equinox Offer is likely to deter altnet entry and expansion. Notwithstanding KCOM's view that Ofcom should reconsider its entire analytical framework (see Section 4), we believe that Ofcom's reasoning (and hence its conclusions) are flawed.

Weaknesses in Ofcom's assessment of the price of products under Equinox

5.2 In its consultation, Ofcom considers whether the prices offered under the Equinox offer are likely to undercut altnets' costs. Openreach argues that "efficient" altnets can compete with the discounted prices, since they are all above the "regulated FTTP 40/10" price.

5.3 Ofcom concludes that, because the FTTP 40/10 product is not discounted under the Equinox offer, and that all other FTTP products are offered at a higher price, that altnets *must* be able to recover their costs even if they cannot charge above Openreach's discounted prices.[9]

5.4 To justify this conclusion, Ofcom refers to supporting analysis included in the WFTMR statement,[10] specifically a bottom-up model which shows that a hypothetical altnet can recover its costs on the basis of sales at 40/10 prices alone.[11]

[9] Ofcom Equinox Consultation, para 2.34.
[10] Ofcom Equinox Consultation, para 2.31.
[11] WFTMR Statement, Annex 15, and Volume 4, paragraphs 1.36-1.38.

5.5 While this model may have served various purposes in the WFTMR,[12] it is not a sufficient ground for drawing a "top-down" conclusion about altnets' costs. It is important to recognise that bottom-up models of this kind tend to be better at identifying cost structures and drivers than the absolute level of costs.

5.6 In fact, if Ofcom considered that its bottom-up model *was* a reliable method for identifying the efficient costs of an altnet competitor to Openreach, Ofcom would have no need for altnet competition, and it could instead regulate Openreach's prices as a monopoly on the basis that it knows the efficient costs of a (hypothetical) rival. But Ofcom did not do this, since it recognises this uncertainty about efficient costs – and instead put in place the WFTMR. It is surprising then that Ofcom relies upon this model for drawing strong conclusions about the impact of the Equinox offer on altnets.

5.7 There are a number of particular reasons why Ofcom's model (like any bottom-up model) risks drawing false conclusions:

5.7.1 First, bottom-up models suffer from errors of omission, as a cost is omitted unless it is specifically identified and included.

5.7.2 Second, Ofcom's model uses an oversimplifying assumption about opex, namely that it is a percentage of Gross Replacement Cost. This assumption is unlikely to hold in practice and is particularly simplistic when used to consider the effect of Equinox on altnets.

5.7.3 Third, Ofcom's model makes assumptions about key parameters, such as utilisation rates of equipment and the take up rate of the services. Ofcom's model may be highly sensitive to assumptions about these parameters.

5.8 In any case, Ofcom's model shows that the "upper bound" estimate of an altnet's costs are only marginally below the price of the 40/10 product, meaning that only a small error in the model's parameters would imply that an altnet's revenues would not cover its costs.

5.9 Ofcom may ordinarily draw comfort from such an assessment for the purposes of a BAU investigation where safeguarding competition is its only aim – and it is agnostic to the precise identities of the firms, products or technologies that succeed or fail. However, it is unwise to rely on a model of this type in a situation where it is pursuing a *strategic* objective where it does care about the identities of the firms – and particularly the technologies – that succeed or fail. Ofcom must adapt its conventional competition tests

[12] In the WFTMR, Ofcom used this model to draw conclusions about incentives for altnet investment in Area 2, and potential returns Openreach could make from fibre network investment in Area 3.

to the specific context, or risk making decisions that are incompatible with its stated vision for the sector.

5.9.1 This means taking into account the impact on expected (probability-weighted) cashflows for an investor – including the impact across the bandwidth gradient – rather than just a superficial assessment in a particular scenario.

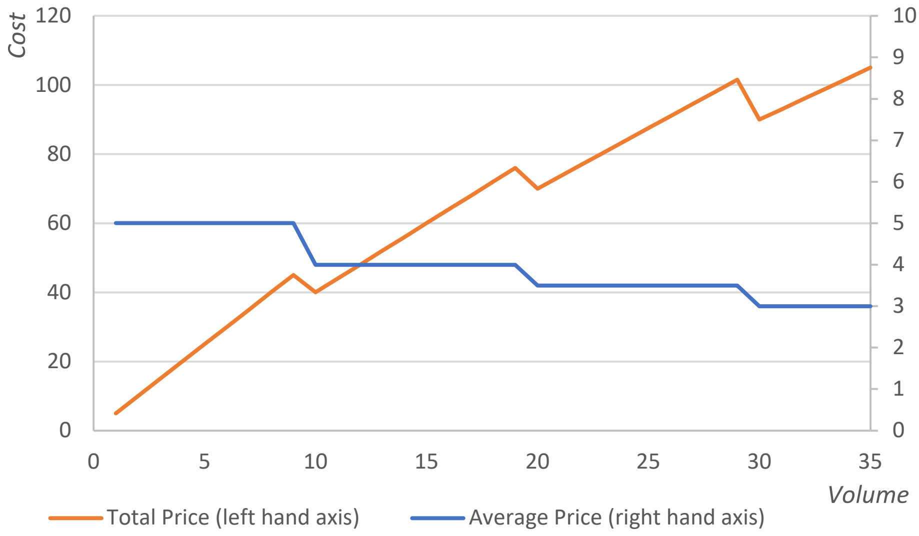
Flaws in Ofcom's assessment of discounts under the Equinox offer

5.10 Ofcom's reliance on this modelling to assess the Equinox offer suffers from a second flaw. Ofcom's model fails to take account of the scale and structure of discounts offered as part of the Equinox offer – and the powerful effect that these may have on ISP purchasing decisions in different areas:

5.10.1 Ofcom's contention is that the effect of the discount on average monthly rental charges will be minimal across an ISP's customer base – and hence it will have no effect on the ISP's decision on whether to purchase wholesale network access from Openreach or a competing altnet. However, this reasoning is flawed and mischaracterises the nature of the purchasing decisions that ISPs will make across the country.

5.10.2 To analyse whether the Equinox offer sets a price that is below the altnet's cost for any given contested sale, Ofcom should instead focus on the marginal price offered by Openreach and the marginal cost for the altnet of providing the contested volume.

5.10.3 The Equinox offer is a "Saw tooth" discount, where, once a threshold is met, the discount is applied to all sales. We illustrate a hypothetical saw tooth discount scheme in the graph below, where the total price line (shown in orange) sharply declines when volume thresholds are met. One feature of a saw tooth discount is that the marginal price for units close to the discount threshold are materially different from the average price, and may be negative, as in this illustration.



5.10.4 In the case of the Equinox Offer, there is a single "saw tooth", given by the point at which Order Mix Targets apply. It is not clear why Ofcom has concluded that the Equinox Offer is not problematic, when it has previously held "there should be a presumption that saw tooth discount schemes which incorporate services from SMP markets are unduly discriminatory."[13]

5.10.5 Consider the following example:

5.10.5.1 Suppose Openreach applies a 20% discount to all sales if an ISP reaches a target of 80% sales on FTTP. Put another way, the full discount comes into effect in relation to all FTTP sales when the ratio of connections on FTTP lines to non-FTTP (e.g. legacy copper) lines reaches 80%.

5.10.5.2 Consider a contested sale of 100 lines in an area where the ISP can choose between Openreach and an altnet. The ISP's starting point is that it has 400 Openreach lines, 300 FTTP and 100 non-FTTP, so the FTTP/non-FTTP ratio is 300/400, or 75%.

5.10.5.3 If the 100 lines of contested sales go to Openreach, there are 400 FTTP lines and 100 legacy lines, so the ratio is 400/500 (i.e. 80%) and the discount is triggered.

[13] Ofcom (2004), *BT's Pricing of Services for Business Customers*

5.10.5.4 If the discount is 20%, and since this applies to all 400 FTTP lines, the effective discount on the marginal cost of the contested 100 lines is 80% (a 20% applied to 400 lines).

5.10.5.5 If the Altnet starts out by charging Openreach's non-discounted price, it would need to offer a discount of 80% on the contested lines to match the effective discount given to the ISP if it selects Openreach.

5.10.6 As this example shows, a saw tooth discount makes it possible that there is a much larger discount on the marginal contested volume than implied by the notional discount rate. Since ISPs may source from multiple suppliers in a given area, the saw tooth design of the discount will materially affect the marginal price faced.

5.11 ISPs will likely make purchasing decisions in each geographical area, as their choice of wholesale network providers and customer base varies. Therefore, what is relevant to the purchasing decision is not the average price offered by Openreach across the ISP's entire footprint – but the marginal price it faces in the relevant geographical area for the contested volume at the point of making the purchasing decision.

5.12 By making the assumption that ISPs will not source in this way, Ofcom reaches a conclusion that the discounts would have no effect. In fact, Ofcom's approval of the discounts may lead to altnets being unable to compete for significant tranches of volumes to serve ISPs.

5.13 Another feature of the Equinox Offer is that it triggers different behaviour in different geographical areas, because competitive conditions (and the alternatives faced by an ISP) are different in different areas. The offer (and its Order Mix Targets) apply across areas where Openreach has a FTTP monopoly and areas where FTTP will be available from both Openreach and (one or more) altnet.

5.14 Since an ISP could benefit from the discount on all their sales (in Openreach and altnet areas) as a result of changes in their mix of orders in the altnet area, the effective discount can be many times larger for a set of contested sales in the altnet area.

Effect of Order Mix Targets on incentives to use altnets

5.15 Ofcom conducts an assessment of whether the Order Mix Targets in the Equinox offer may deter ISPs from using altnets, because choosing an altnet in a contested area would reduce the ISP's ratio of FTTP-connected customers on the Openreach network, which may mean it does not reach the Order Mix Target that makes it eligible for discounts.[14]

5.16 Ofcom "provisionally" concludes that Order Mix Targets do not deter ISPs from choosing altnets, finding that it is plausible ISPs would surpass the Order Mix Targets, and that even if some "struggle to meet" the targets, that they are very likely to meet them in the medium term, because the "challenges [of meeting the targets] would be temporary".[15]

5.17 Openreach's supposed purpose in offering the Equinox offer is to change the behaviour of ISPs, so that they buy (and sell-on) Openreach FTTP products. Therefore it is unlikely to deliberately set the targets too high or too low such that they do not change behaviour, since doing so would simply deprive Openreach of revenue. Therefore Ofcom's implicit conclusion that it is reasonably *likely* that ISPs will easily meet the Order Mix Targets, seems unreasonable.

5.18 Ofcom's finding that, even in its most pessimistic scenario, it expects ISPs to only face "temporary challenges" in meeting the Order Mix Targets, is also unreasonable. If it were the case that ISPs will easily reach the targets in the medium term, and that the Equinox offer would not incentivise a change in ISPs behaviour in the short term, this would again mean Openreach is irrational (or otherwise wrong) to offer a discount.

5.19 Instead, it is highly plausible that the Equinox offer would have a material effect in the short run. This assessment is supported by the fact that the discounts induce a long-term lock in even though Openreach may offer them to ISPs for a short time. As discussed in Section 4 above, this is likely to deprive altnets of a large part of their potential customer base at the point at which it is most important for incentivising investment in altnets, and thus providing competitive pressure on Openreach.

6. Conclusion

6.1 Ofcom proposes to approve Openreach's Equinox Offer on the grounds that it considers the offer does not materially affect ISPs incentives to use altnets, and that it therefore does not raise sufficient competition concerns to justify ex ante intervention.

[14] We note Openreach's argument that, because altnet orders are excluded from both the numerator and denominator of the Order Mix Targets, that using an altnet has no effect on ISPs ability to meet the Order Mix Targets. While Ofcom cites this argument in its consultation, it is not clear that Ofcom relies upon this justification in concluding the Order Mix Targets do not affect ISPs incentives. However, we note that Openreach's argument is incorrect, because the Order Mix Targets are set in percentage terms. If one subtracts the same number from both the numerator and denominator of a fraction, the fraction becomes smaller, for instance, 3/4 (75%) is smaller than 4/5 (80%).

[15] Ofcom Equinox Consultation, paras 2.47 and 2.54.

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6.2 In fact, the Equinox Offer raises material competition concerns, and Ofcom's analysis in its consultation is insufficient for assessing them.

6.3 Specifically, Ofcom has made a number of mistakes in its analysis. It relies upon a framework which makes deterministic assumptions about (what Ofcom considers to be) the most likely outcomes of the Equinox offer, rather than evaluating and quantifying the costs and benefits of all plausible scenarios. It also fails to properly consider the effect of the Equinox discounts on localised competition, and the effect of Order Mix Targets on ISPs incentives to choose Openreach over altnets.

6.4 **[Redacted]**.

6.5 Openreach has stated ambitious full-fibre expansion plans. However, stymied investment by altnets will reduce the incentive for Openreach to deliver on its own investment plans at its current pace. Hence the gigabit society envisaged in Ofcom's WFTMR risk being undelivered, and many households and businesses may miss out on the high-speed broadband they expect by 2026.

6.6 Therefore, we consider the Equinox Offer raises sufficient competition concerns to require Ofcom to issue a direction to prevent the offer.