Fern Trading Limited's Response to Ofcom Equinox 2 Consultation

"*__The Government's view is that promoting investment should be prioritised over interventions to further reduce retail prices in the near term__*."[1]

Summary

1. If approved, the Openreach Equinox 2 ('OR' 'E2') discount offer will deliver major savings on wholesale network access for ISPs able to meet the Order Mix Targets ('OMT's'). It is unclear how many ISPs will reach the required threshold, or what level of discount they will receive. And it is debatable how much they will pass on to their customers, rapther than using it to offset rising costs. Nevertheless, we agree that some consumers should see cheaper broadband prices as a result of E2. We fully support this outcome, provided that network-level competition is not harmed, and that any price benefits endure in the long run.

2. However, we do not believe these caveats hold true. First, we are sceptical of Ofcom's conclusion that E2 should give sufficient headroom for network competitors in Area 2 to remain profitable. We note that Ofcom seems unconcerned that prices for three OR fibre products will now be below the price of the 40/10 regulated anchor product, and instead prefers to consider average FTTP prices. This change in approach compared to E1 favours OR at the expense of competitors. In addition, Ofcom seems unconcerned at the prospect of OR increasing prices at the first available contract break point, once competition is weakened.

3. But we strongly disagree with Ofcom's approach to E2's wider competitive effects. E2 is a classic dominant provider margin squeeze, which makes it harder for other providers to compete. As E2 discounts apply equally throughout the UK, their impact will be felt most keenly in locations where build costs are highest, i.e. in the less densely populated towns and villages of Area 3. While competition may be weakened in Area 2, particularly in its more rural locations, in some parts of Area 3 it will become entirely unsustainable.

4. In this consultation, Ofcom has dismissed concerns about the relevance of Area 3 in assessing E2's competitive in a couple of footnotes[2]. It says it does not believe that

[1] UK Government's *Statement of Strategic Priorities*, July 2019, paragraph 18.
[2] Ofcom E2 Consultation, page 24.

material and sustainable competition to OR is likely in Area 3, and therefore does not consider that it is problematic that E2 sets the same rental charges in Area 2 and Area 3.

5. The premise of Ofcom's position is wrong. Taking each of Ofcom's doubts in turn:

- **Materiality**. Figures from both ThinkBroadband and INCA show that altnets have *already* deployed to around 1.2m Area 3 premises. The INCA survey shows that altnets plan to extend their build to 6m premises by 2026, i.e around two-thirds of Area 3, of which 4.9m are expected to be offered on a wholesale basis[3]. This figure is clearly "*material*".
- **Competition**. What's more, it is clear that altnets will "*compete"* with OR in most of these places; exactly like altnets, BT plans[4] to cover 6m premises in the "*hardest-to-serve parts of the country*". According to the INCA data, this suggests there will be wholesale network overlap in roughly 4.9m Area 3 premises.
- **Sustainability**. While Ofcom may question the "*sustainability*" of *some* altnet plans, it cannot write them *all* off[5]. Many of these business plans are backed by major UK infrastructure investors. They are at least as credible as those of OR, with its declining revenues, and net debt of £19bn[6].

  Nor can Ofcom assume that, despite plans from both altnets and OR to reach 6m Area 3 premises with fibre, only one of them can win in the long run. Fern's plans to pass [REDACTED] premises, of which [REDACTED] are in Area 3 (with the remainder in the deepest parts of Area 2), assume eventual 100% overbuild by *at least* one other provider, whether OR or another altnet. We would be surprised if other major altnets didn't take the same view.

  In any event, it is *Ofcom* that will play the major role in determining sustainability. If it allows the incumbent to charge prices which allow for competition in Area 2 but not in Area 3, then some Area 3 networks will become no longer viable. The effect of such a decision by Ofcom will be to limit network competition to cities and major towns, when it has the potential to extend to at least 25m premises.

6. We think Ofcom does not properly understand the economics of rural deployment. It has historically either refused to accept altnet claims about the extent of their Area 3

[3] Less than 4% of these are expected to be subsidised.

[4] https://www.openreach.com/news/openreach-focuses-broadband-build-plans-on-upgrading-millions-more-rural-homes/

[5] Equally, it should question OR's sustainability, in the light of its massive net debt issues.

[6] BT quarterly results, September 2022

business plans, or has not accepted their sustainability. The new data on both actual and planned altnet build show that material and sustainable competition to OR *is* likely in Area 3, and that therefore it *is* problematic that E2 sets the same rental charges in Area 2 and Area 3.

7. It should be clear to Ofcom that the primary objective of Equinox is to undermine alternative network build, particularly in the more rural parts of Ofcom's Area 3. If Ofcom is serious about supporting network investment by providers other than OR, it should do one of the following:

   a) not approve the E2 offer;

   b) if it must accept the offer, then ensure it does not apply in Area 3; or

   c) put the offer start date back until the end of the current market review period, by which time OR will have had the benefit of the WFTMR charge control, and around 75% of the UK will be fully fibred.

Ofcom has changed the goalposts. Three of OR's slower FTTP products will be priced below the regulated 40/10 anchor product. These would have failed the E1 test.

8. Ofcom's analysis of the competition concerns raised by E2 rests on the question of "*the extent to which altnets in Area 2 could profitably compete against Openreach's average FTTP price under the Equinox 2 Offer*". Ofcom finds that the E2 price is above the top end of the estimated range for the unit cost of an efficient FTTP entrant in Area 2, and that therefore they should be able to compete. However, in arriving at this view, Ofcom appears to have changed the test it thinks should apply.

9. In its Equinox 1 ('E1') statement, Ofcom determined that the offer posed no risk to competitive network investment on the basis that the discounted prices for *all* of OR's FTTP products were set above the regulated price ceiling for the 40/10 anchor product, and above the efficiently incurred build costs of a new entrant.

10. Ofcom said, *"Further, **all other** FTTP rental prices under the Equinox Offer are set a level above this, including when ARPU-related discounts are taken into account. **Therefore**, we consider that the Equinox Offer prices are set at a level above our estimate of the price that an altnet would need to charge in order to recover its efficiently incurred costs in Area 2."*[7] (emphasis added).

[7] E1 Statement, 3.44, Sept 2021.

11. As three E2 higher bandwidth products are priced beneath the anchor, E2 would not have passed the E1 test. But Ofcom now says it would only be concerned only if the *average weighted* price of OR FTTP products fell beneath the regulated 40/10 anchor. It believes E2 passes this new test.

12. What's odd about this, is that in the WFTMR, OR argued for a premium of at least £2 for its 40/10 fibre anchor relative to its legacy product equivalent. Ofcom accepted this argument, and applied a £1.70 premium. It stated that the 40/10 product delivered "*additional benefits to end-users in terms of greater service reliability with higher and more stable speeds (relative to broadband provided over copper with the same stated headline speed)*" and "*additional benefits to access seekers purchasing a fibre broadband service as a result of cost-savings through delivering a more reliable service to customers; and lower exchange-based costs*".[8]

13. It appears that neither OR of Ofcom feel the need for a premium for lower speed fibre products over copper any more.

Ofcom should expect this to result in a lessening of competition in the supply of entry-level fibre, to the detriment of lower income households.

14. The practical impact of this is that competition in lower speeds products, where OR prices are beneath the anchor, will diminish. Ofcom should expect fibre providers to withdraw their slowest products, to the detriment of households which can only afford entry-level fibre.

OR is cross-subsidising Area 3 build.

15. The E2 offer applies the same discount levels to all premises in Areas 2 and 3. OR has looked at the build costs across its entire UK footprint, and set its wholesale prices accordingly. If its competitors also operated on a national scale, or in Area 2 only, this might be fair.

16. But for competitors operating largely, or even partly, in Area 3 (or the lower end of Area 2), where build costs are significantly higher, this means they must now compete with wholesale prices set by reference to locations where OR build is cheaper. Effectively OR is able to use national dominance to cross-subsidise its Area 3 build. The impact of cheaper rental prices on Area 3 competitors is compounded by the introduction of a new Area 3 connection discount.

[8] WFTMR: Annexes 1-26, Annex 19, para A19.13 – A19.14.

OR's build plans show that Area 3 commercial viability is greater than Ofcom expected.

1. Ofcom's conclusion that this does not pose a problem for competition rests on its belief that in Area 3 "*there is not, and there is unlikely to be potential for, material and sustainable competition to BT in the commercial deployment of competing networks*"[9]. If Ofcom is right on this, then the E2 discounts should not matter in Area 3, and there is no need for it to examine the additional challenges to ISPs of meeting OMTs there.

2. Before examining the hypothesis, it's worth looking at the viability of Area 3 for just a *single* network. In the WFTMR, Ofcom thought that even OR, with all of its cost and incumbency advantages, would deploy only minimally in Area 3 unless incentivised through regulation. It therefore offered a favourable price control on the anchor 40/10 product and the benefits of a 'Regulated Asset Base' approach to recovering its network investments.

3. It turned out that OR did not need any incentive to invest in Area 3. Shortly after it had pocketed its regulatory dividend, it announced it would pass millions more homes in locations where build costs were even more expensive than those Ofcom thought it would not take on without regulatory support. As Ofcom appears to believe that OR build plans are more accurate than those of altnets, it should now recognise that it got the economics of Area 3 wrong.

4. The reason for this is simple. It's because the *majority* of Area 3 is commercially viable, without subsidy or regulatory intervention, in the long run, for both OR and altnets. Fern companies have repeatedly made this point to Ofcom during WFTMR and Equinox consultations and meetings, but Ofcom has been unwilling to accept it.

***Most* of Area 3 will sustain competition between at least two networks in the long run.**

5. Ofcom has never been clear whether its doubts lie with the idea that competition in Area 3 could be "*material*" in scale, or whether it accepts that material competition might arise but thinks this will prove "*unsustainable*" in the long run. We now examine both points.

[9] WFTMR Vol 1, 2.34, March 2021.

6. The latest data from INCA[10] and ThinkBroadband[11] provide incontrovertible evidence on "*materiality*". Based on responses from 20 companies, INCA found that altnets have already passed 1.2m Area 3 premises. This is almost identical to ThinkBroadband figures, which show that 44.94% of 9.4m Area 3 premises are currently covered by full fibre, of which altnets account for 12.19%, equating to roughly 1.1m premises.

7. Further, INCA found that altnets planned to deploy to 6m Area 3 premises by 2026, i.e around two-thirds of the total, of which 4.9m are expected to be offered on a wholesale basis[12].

8. In terms of "*sustainability*", Ofcom may doubt the viability of some altnet business plans. It may think that even if both OR and altnets plan to cover the same 6m Area 3 premises, there can only be one winner in the long run. However, this betrays a lack of understanding of the economics of rural build. Fern company business plans are built on the assumption that their *entire* Area 3 footprint will be over-built by OR or another altnet (or both). It's just a matter of how long this takes. We would be surprised if our large competitors aren't making similar assumption.

9. Furthermore, the fact that altnets have *already* covered around 1.2m premises in locations where Ofcom thought that material competition to OR was unlikely, should at least make it pause and reflect on sustainability. It does not matter that the altnet industry is likely to consolidate in the near-term. There will still be at least one alternative Area 3 network operator unless the consolidator is OR, which seems unlikely.

10. Ofcom cannot credibly question the sustainability of *all* altnet plans, particularly those backed by the larger UK infrastructure investors. In fact, we suggest it would be more prudent to question BT's sustainability, with its declining revenues, and its net debt of £19bn[13].

11. In any event, the most important point here is that sustainability is *largely within Ofcom's gift*. It can either support the dominant incumbent by allowing major wholesale prices reductions which disproportionately affect those building to

[10] See INCA response to this consultation.

[11] https://www.thinkbroadband.com/news/9487-february-2023-update-on-broadband-coverage-in-ofcom-areas-2-3

[12] Less than 4% of these are expected to be subsidised.

[13] BT quarterly results, September 2022

millions of homes in more sparsely populated areas, or it can give nascent competitors some breathing space. If it opts for the former, Ofcom will make some deployments unsustainable.

Material and sustainable Area 3 competition means that applying the same prices as in Area 2 creates a widescale problem.

12. Ofcom dismisses the notion that it should apply its analysis of the competitive impacts of E2 to Area 3 in a footnote. It says, "*We recognise that FTTP build costs vary across geographic locations and expect them to be typically lower in Area 2 than in Area 3. However, in the WFTMR Statement we did not pursue an approach of setting higher wholesale FTTP prices in Area 3, given our conclusion that material and sustainable competition to Openreach in Area 3 was unlikely. As a result, we do not consider that it is problematic that the Equinox 2 Offer sets the same rental charges in Area 2 and Area 3.*"[14]

13. The implication of this is that if turned out Ofcom had *misunderstood* the market, and that in fact material and sustainable competition to OR *did* develop in Area 3, Ofcom *would* have pursued an approach of setting a higher wholesale FTTP price in Area 3. It would also have viewed the setting of identical rental charges in Areas 2 and 3 as problematic. For the reasons set out above, we submit that the evidence strongly suggests that material and sustainable competition in Area 3 is highly likely.

14. Ofcom goes on to say, "*In any event, even if we had incorrectly categorised a location as being in Area 3 rather than in Area 2 (as claimed by INCA and Zzoomm), this would not affect our assessment. In this scenario, the costs we have modelled (i.e. those of an altnet in Area 2) would apply to an altnet that was building in that miscategorised location*"[15].

15. Ofcom has misunderstood this issue. The problem is not that it should have applied its Area 2 build costs to the 6m Area 3 premises it miscategorised as competitively non-viable in Area 3. The issue is that *even though* build costs are much higher in these locations than in Area 2, altnets can still operate Area 3 networks profitably *provided OR's competing prices reflect its own Area 3 build costs*. With E2, OR does no such thing. Instead it applies pricing which supports its blended *national Area 2 plus Area 3* build cost, to Area 3.

[14] E2 Consultation, footnote 84.
[15] E2 Consultation, footnote 85.

16. Ofcom sort of acknowledged this in the E1 statement. It said: "*While we were aware of plans for rival network build in some locations in Area 3, the relatively higher build cost per premises and the significant variation in these costs across Area 3 means this is unlikely to occur on a widespread basis. Therefore, the benefits of such a policy are likely to be small, relative to the costs imposed on all consumers in Area 3 who would face higher FTTP prices*"[16].

17. Thus Ofcom recognises it cannot apply its Area 2 modelled costs to a location in Area 3 which turned out to be commercially viable. It just believes this won't happen often. This limits the impact of any intervention to prohibit Equinox discounts in Area 3. Once again, Ofcom should consider the latest evidence. Widespread sustainable competitive build in Area 3 is *highly* likely, albeit at higher cost than in Area 2. It is disproportionately affected by higher FTTP prices.

Ofcom should examine footprint overlap between wholesale aggregators and OR.

18. In addition, Ofcom focuses solely on overlap between individual altnets and OR, noting that "*if that altnet is only present in a tiny fraction of the Openreach FTTP footprint then any potential impact on the overall Order Mix is likely to be small*."[17]

19. Ofcom does not appear to have considered the possibility of altnet footprint aggregation in this analysis. At least two nascent wholesale platforms already emerging, which will offer ISPs access to the combined fibre premises of multiple operators; Fern's own *Vitrifi,* and the *Common Wholesale Platform*. It is the overlap between OR and these combined entities going forward that Ofcom should consider.

Ofcom needs to review the impact of low wholesale prices in Area 3.

20. Ofcom says that the OR 90-day notification requirement is for commercial terms where the price or other contractual conditions are conditional on the volume and/or range of services purchased. It says, "*it is not intended to address general concerns about low wholesale prices.*"[18]

21. But Ofcom must recognise that volume discounts are likely to have the effect of lowering *both wholesale and retail* prices in Area 3, and that this risks making some build unsustainable. At the very least it will lead to a scaling back of network

[16] E1 Statement, 3.47.

[17] E2 Consultation A7.2.

[18] E2 Consultation 3.98.

deployments. By accepting E2, Ofcom will promote near-term price reductions at the expense of long-term investment in competing fibre networks.

22. We support the need for stable regulation, and therefore accept that revisiting the WFTMR decision is not something Ofcom should do lightly. Nevertheless, a lot has changed since the data for WFTMR was collected nearly three years ago, and Ofcom published its statement two years ago. In particular, Ofcom's assumptions about Area 3 have just not been borne out by the development of the market.

23. Harking back to something that is now quite out of date, thanks to the billions of pounds of private capital that has flooded into the altnets, is doing a dis-service to the role that Ofcom, DCMS and altnets have played in helping to upgrade the UK's rural digital infrastructure. The threats posed by wholesale prices which cross-subsidise from Area 2 on this development must merit an urgent regulatory review, even if this is done outside the E2 decision. Absent such an examination, Ofcom should expect rural broadband deployments to slow down.

Conclusion.

24. Ofcom has the power to make decisions which either encourage network competition in Area 3, or stifle it. Absent E2, around two thirds of the premises that Ofcom thought could only be reached by OR, will be reached by altnets, according to their forecasts. The majority will ultimately compete with OR, on a wholesale basis. But if Ofcom allows the E2 discounts in Area 3, it will reduce rural network competition in favour of short- to medium- term price drops.

25. So, while it is questionable whether network builders have enough headroom in the more sparsely populated parts of Area 2 to reduce prices and remain competitive with the E2 discounts, this is certainly not the case in Area 3. And because Ofcom has not understood the scale of commercial deployment in Area 3, it has not assessed the impact that E2 will have on investment Area 3 gigabit-capable networks. The larger existing operators may be able to compete with cheaper prices at the wholesale and retail level, but the emerging operators, which Ofcom has otherwise done well to promote, won't.

26. In approving E2, Ofcom risks depriving potentially millions of households in less densely populated areas from the long-term benefits that network-level competition brings. If Ofcom is serious about regulating to encourage large-scale deployment of new full-fibre networks to homes and businesses *across the country*, and

encouraging BT's competitors to build their own networks, rather than relying on network access from Openreach, then it should do one of the following:

a) not approve the E2 offer;
b) if it must accept the offer, then ensure it does not apply in Area 3; or
c) put the offer start date back until the end of the current market review period, by which time OR will have had the benefit of the WFTMR charge control, and around 75% of the UK will be fully fibred.