G.Network
100% FIBRE CONNECTIVITY

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Dear Lindsey,

Openreach's Equinox 2 pricing proposals

Further to our meeting with you and your colleagues in December, I am writing to offer some thoughts relevant to Ofcom's consideration of the recent 'Equinox 2' pricing proposal from Openreach. By way of context, I would like to record that we have the highest respect for Ofcom and for Openreach and offer the points below hoping to be useful to you in your deliberations.

As you know, G.Network is a leading provider of FTTP in London. We have passed ✂ premises in central London and have recruited ✂ retail customers. Our strategy is to be an open access wholesale network available for all retail Internet service providers. We have been ✂. As such Openreach's pricing is an important issue for us.

We would like to raise a few concerns for your consideration. We feel it is important that regulatory decisions regarding Equinox 2 and other FTTP matters are informed by the wider context. The FTTP sector is seeing significant change – both positive and negative – and your continued vigilance is essential to ensure the emergence of healthy competition. This letter sets out G.Network's perspective on the sector, and what we see as the regulatory implications.

Ofcom's interventions have been successful in supporting market entry and investment

Ofcom took the decision to encourage BT's rivals to build their own networks, since it believed "competition is the best means to ensure continued investment in building and maintaining high quality, future-proofed telecoms networks."[1] We support this approach.

Ofcom put in place a range of interventions to encourage build, including: enhanced duct and pole access; setting Openreach's regulated tariffs based on CPI indexation and with an eye to the cost base of an efficient market entrant; and limits on geographic discounts. We support these interventions. In particular, we would like to emphasise that CPI indexation of wholesale prices is important to the infrastructure investors investing in fibre networks who

[1] Ofcom, [Promoting competition and investment in fibre networks: Initial proposals – Approach to remedies](), 29 March 2019

are the long term funders of competitive infrastructure. In practice we have made only limited use of PIA in our network footprint to date. ✂. As we expand our network into a wider area of London, we expect to use more of Openreach's PIA infrastructure.

G.Network and other altnets have responded to Ofcom's encouragement and introduction of CPI linked regulated tariffs with substantial investment. Approximately 100 companies are now deploying fibre. By end-2021 altnets had passed 5.5m premises, and that figure has likely doubled since.[2] G.Network has so far invested ✂in FTTP in London, about ✂ of which is in the form of debt finance. ✂. Ofcom's decisions are crucial to how the market will evolve and the opportunity for competitive investment.

This competition can deliver value in multiple ways:

- *It provides choice*, both for consumers through retail offers, and for ISPs as wholesale customers. For decades ISPs (Virgin Media aside) have had little choice but to use Openreach. Increasingly they have an alternative.
- *It provides a spur to Openreach*. Competition encourages Openreach to improve its quality, pricing and coverage. Equinox 2 is a case in point. It is hard to imagine Openreach offering such discounts if it weren't concerned about competition. More generally, it is striking how Openreach's fibre deployment plans have been transformed by the advent of serious infrastructure competition. Each pound of altnet investment could be said to 'count twice' – once for the direct benefits of the fibre deployed, and once for the impact on Openreach's offer to its customers.
- *It can lead to deregulation*. Competition in the wholesale market may allow Ofcom to remove price regulation in certain geographies in time and allow outcomes to be determined by the market instead. We support this direction of travel.
- *It provides network diversity*. Corporate users recognise the value of redundant connections, and altnet fibre brings fully diverse networks to more of the UK, enabling greater flexibility in the siting of premises that need this redundancy. More generally, it is now recognised that broadband is a critical element of national infrastructure, and thus diversity is increasingly important for all users.
- *It supports copper switch-off.* Altnets and Openreach together will encourage customers to transition to FTTP more quickly than Openreach could alone. This brings forward the date of copper switch-off, which will provide significant savings and a long term environmentally sustainable infrastructure.

The upgrade to FTTP is a once-in-a-generation chance to establish access competition

Ofcom's support for access competition via FTTP is particularly important because the upgrade to full fibre is a once-in-a-generation opportunity. The benefits of infrastructure competition are not a new idea – they have been understood since the earliest days of deregulation. Regulatory concepts such as the ladder of investment had access competition

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[2] Point Topic [for INCA], *Metrics for the UK independent network sector Including results from Spring 2022 survey*, May 2022

as their ultimate objective. However, such competition in fixed networks has been extremely limited (other than from cable networks) until the advent of FTTP.

The need to rebuild the access network using fibre somewhat levels the playing field between Openreach and other players. While Openreach continues to have important advantages, the construction of rival networks has the potential to be economically viable.

However, the fact that market entry depends on this upgrade to FTTP also highlights the window of opportunity is limited. If access competition is *not* established in parallel with the national upgrade to FTTP, then the next opportunity to facilitate infrastructure competition in the access network may not arise for decades.

However, sustained and effective competition is not yet 'locked in'

Currently, this opportunity to establish competition remains work-in-progress. While there has been significant funding, future funding remains at risk. While there has been significant deployment, the viability of altnets is at risk. In certain locations, altnets have traction with customers (both retail and to some extent wholesale). However, from a national perspective the market share taken by altnets remains limited. Ultimately, it is market share that will both justify continuing investment in the medium term and beyond, and will ensure the viability of altnets as competitors to Openreach.

The four largest ISPs (BT, Sky, Virgin and TalkTalk) have 88% share of the market.[3] Of these, only TalkTalk (with 9% share) makes material use of altnet fibre, and even this is over only a fraction of its national footprint. Many of the smaller players either use Openreach or sometimes wireless solutions, rather than altnet fibre. The largest retail altnet is Hyperoptic, with 0.3% of the market, whose infrastructure is in many cases not pure FTTP.

Overall, INCA/Point Topic figures suggest approximately 5% of broadband customers use altnet fibre (either directly, or via an ISP buying wholesale from an altnet).[4] This already modest share is spread across the 100 companies investing in FTTP. While altnets' share is growing, it is clearly some distance from a level that is likely to be viable over the long term, particularly given the substantial investment required. It is a slow process to get retail customers to switch provider. In central London G.Network has faced the additional barrier of the time, cost and complexity of negotiating wayleaves for a large number of small multi-dwelling units, with multiple levels of complex ownership structures to enable us to connect customers. It is often easier to build FTTP in the street than to connect customers with a fibre through the building.

The wholesale market in competition with Openreach is in its infancy. We are aware of only one significant altnet wholesale provider, CityFibre, who have contracts with, and retail

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[3] Ofcom, *Technology Tracker 2022* [Table 71], 24 June 2022. Figures rebased to exclude 'don't knows'. Sub-brands (such as BT's Plusnet) included in parent

[4] Based on Point Topic [for INCA], *Metrics for the UK independent network sector Including results from Spring 2022 survey*, May 2022; Ofcom, *Telecommunications Market Data Update Q2 2022*, October 2022. See also ThinkCX, *UK Fibre Wars – fresh data shows how fast independent altnets are eating into incumbent ISPs' market share*, 24 November 2022

customers through, Vodafone and TalkTalk (the latter achieved though the acquisition of FibreNation). We are aware that there are a few other smaller contracts with TalkTalk – Freedom Fibre in Manchester and Community Fibre in London – but ✂. G.Network ✂.

Thus, for the time being, the benefits of altnet competition to the wider market are to a large extent driven by the threat of future growth, not the altnets' current market position. This does not make the benefits any less real – FTTP deployed by incumbent players has tangible value to the market, regardless of whether it is prompted by an immediate or future competitive threat. However, it does highlight that continuing growth of the altnets is critical both to their direct benefits to consumers and to sustaining the competitive spur they bring to the market.

Wider market developments that could threaten altnet growth

Thus if the UK is to take the generational opportunity to secure sustainable access competition, it is vital to be alert to market developments that might threaten current investment and stop a critical mass of altnets achieving long-term viability.

One such development is the change in the financial environment. Many altnets rely heavily on debt to finance their roll-outs, but this debt has become both more expensive and harder to secure.

The benchmark SONIA interest rate has jumped from 0.05% in December 2021 to 3.4% currently (a level last seen in 2008).[5] This is particularly problematic for businesses - such as telecoms – with long pay-back periods. ✂ payback periods are not unusual for FTTP deployment, and this increased cost of debt must be paid over that extended period.

This feeds into the appropriate regulated pricing of Openreach's products. One consideration for Ofcom when determining the price for the 40/10 Mbps anchor product was whether it would allow reasonable headroom when compared to the cost base of an efficient competitor.[6] (If not, it risked foreclosing efficient market entry). The WACC that fed into this assessment was based on the real yields of 10 and 15 year gilts at the time, which were around -3%.[7] Today they are around 0%.[8] In G.Network's case, ✂.

Such increases in the cost of capital suggest that the assessed cost of the efficient entrant would now be appreciably higher than Ofcom's previous estimates, and thus that there is a risk the regulated price no longer allows for efficient market entry which will deter competition from additional equity investment in the sector without the prospect of higher real prices to generate real returns.

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[5] Bank of England, *Data Viewer* [accessed 24 January 2023]

[6] ¶1.37, Ofcom, *Promoting competition and investment in fibre networks: Wholesale Fixed Telecoms Market Review 2021-26. Volume 4: Pricing remedies*, 18 March 2021

[7] ¶A20.40, Ofcom, *Promoting investment and competition in fibre networks: Wholesale Fixed Telecoms Market Review 2021-26 Annexes 1-26*, 18 March 2021

[8] UKDMO, *Result of the sale by auction of £1,100 million of 0⅛% Index-linked Treasury Gilt 2031*, 19 January 2023

This is not to argue that Ofcom's original assessment was in any way flawed – it was based on the best information at the time. Nor do we suggest that Ofcom should constantly adjust tariffs in light of movements in the financial markets. But we do believe this change in the financial landscape is important context for Ofcom when considering other developments (more under its control) that may discourage investment. Openreach's prices could fall to a level that would make efficient entry unviable and it will need Ofcom's vigilance to consider what this level might be.

Moreover, it is not simply a matter of the cost of capital, but the *availability* of capital. There is a growing sense that altnets are going to find it appreciably harder to secure either debt or equity over the coming year.[9] In G.Network's case, ✂. Our view is that lenders require more equity support in capital structures than previously anticipated which gives rise to a higher WACC due to greater contribution of equity and higher cost of equity due to higher risk free rates and a scarcity of equity capital now willing to invest in UK FTTP

This is also an asymmetric problem for the altnets, in the sense that access to new capital is essential to their deployment plans, whereas Openreach is able to self-fund. In the first half of FY2022/23, Openreach invested £1.5bn, of which £1.0bn was in fibre – but this compares to EBITDA of £1.7bn.[10] Considered on a consolidated BT Group basis, £1.0bn of fibre investment is a fraction of their Group EBITDA of over £7bn.

This further underlines the importance of not allowing action by regulation or by Openreach inadvertently to discourage investment. Achieving the perception by investors that altnets operate in a supportive regulatory environment is growing all the more vital.

Impact of changes in Openreach's pricing

Changes to Openreach's pricing also have the potential to erode competition. This is obviously not to say that all Openreach price reductions are problematic. Indeed, such reductions may be seen as precisely one of the reasons Ofcom sought to encourage competition in the first place. Effective competition fosters efficiency and drives out excess profits, and this may manifest in lower prices.

However, we would like to highlight some issues with Openreach's Equinox 2 proposals.

The structure of pricing, with discounts for volumes committed, can have adverse effects on retail ISPs' incentives to migrate to alternative networks.

It is potentially problematic to the promotion of infrastructure-based competition that Openreach is offering a higher speed product at a lower price than the price control of the 40:10 product. Openreach's pricing is not inconsistent with the regulation: Openreach could reduce the price of the 40:10 product itself below the Ofcom price cap, if it wished.

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[9] See, for instance: BDO, *Broadband Headwinds: The altnet challenge and the likelihood of Government intervention*, November 2022; Cartesian, *2022 Year-End Review and Industry Predictions for 2023*, 20 December 2022

[10] BT, *BT Group - H1 FY23 KPIs*, 3 November 2022. Even after interest, tax and movement in working capital, Openreach had positive normalised free cashflow of £64m for the period

However, it has a material effect on the investment business case whether Openreach treats the regulated price as a cap or a control. Investors have typically assumed that Openreach will treat the regulated price as a control and not assume that prices will fall below this level, as has been its consistent practice in the past: now this assumption has been shown to be mistaken, adding greatly to the risk of lower wholesale prices in future. Given that Ofcom set the 40:10 price on a cost-orientated basis, for Openreach to be selling faster products for less could give rise to concerns as to whether new entrants faced with higher costs will be able to compete.

For these lower wholesale prices from Openreach to benefit consumers, they need to be passed through by ISPs. In fact, quite the opposite has happened.

The initial Equinox prices offered discounts to Openreach's previous list prices of 11-30% from October 2021.[11] There was a modest price increase of 2.9% from March 2022, and Equinox 2 provides a reduction of 2.8% from March 2023.[12] But despite this appreciable aggregate reduction in input costs, ISPs have been sharply *increasing* their prices to consumers. In March 2022 BT (for example) increased its broadband tariffs by 9.3%, and have recently announced an additional increase of 14.4% from March 2023.[13] Virgin Media has followed suit.

Regulatory decisions about wholesale price reductions by incumbents can typically involve a trade-off between the short-term interests of consumers (lower retail prices today) versus their long term interests (sustainable facilities competition). However, there is little to trade off if the wholesale price reductions are not in fact delivering lower retail prices, and that is the current reality in the market.

Moreover, the fact that BT (and other ISPs) feel they can push through such increases despite material declines in a key input cost is further evidence that the market is not yet fully competitive at the retail level. In other words, Openreach's lower wholesale prices are a threat to investment and competition without being a benefit to end-customers.

Impact of price uncertainty

Further, the manner of price changes can in themselves be problematic. If there is to be fully effective and viable long-term competition to Openreach, then there needs to be a competitive market for wholesale access (not just competition at the retail level). However to-date there has been very limited movement away from Openreach.

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[11] ¶A6.8, Ofcom, *Consultation: Openreach Proposed FTTP Offer starting 1 October 2021*, 6 August 2021. Excluding 40 Mbps service

[12] 160 Mbps to 1 Gbps products. Openreach, *NGA2026/21 Application of indexation to GEA-FTTP Equinox pricing for 2022/23*, 23 December 2021; Openreach, *NGA2018/22 GEA-FTTP Equinox 2 Offer*, 14 December 2022. All figures in this paragraph in nominal terms

[13] BT, *Annual Price Change*, February 2022. BT, *Our approach to this year's price changes explained*, 18 January 2023

As Ofcom is aware, ISPs face significant switching barriers when moving to a wholesale altnet:

- Openreach is the incumbent. Effectively all retail ISPs have mature systems interfaces, face known service standards and processes, understand wholesale pricing and can count on the largest FTTP network.
- Altnets represent both an opportunity and a risk for ISPs. Their networks are of varying scales and qualities. Their strategic, financial, technical and operational standing has to be assessed and choices have to be made about who to work with.
- Systems are expensive and complex. Substantial work is necessary to integrate systems to enable ordering, fault management and so on; the ISP's customer-facing systems need to be updated to reflect local availability of the new products on offer; the ISP's products may need to be adjusted to reflect the underlying provision; investments in these changes are constrained by the development capacity of the ISPs; the fruits of the work are uncertain in cost, time and quality.
- Further, contracts for such services from an altnet are typically ✂.

In other words, the choice to switch to an altnet is challenging for the major ISPs.

In G.Network's case, ✂.

We believe that ✂ ISPs need very high confidence that the switch is going to deliver value before deciding to change away from Openreach. This value substantially depends on the price difference between Openreach and the altnet in question, since cost savings are generally one of the key benefits from the transition (if Openreach has or plans FTTP in the relevant area). ✂.

We believe that ✂ most progress ✂ with potential wholesale customers when Openreach's pricing has been settled, particularly in the period after the Equinox 1 pricing was agreed. If Openreach's pricing is uncertain, due to the *potential* for further price reductions, then ISPs will see significant risk in the value of the switch – some large part of the cost saving could potentially be achieved, without having to carry the switching cost. It is difficult for competitors to offer commercial terms when the incumbent is signalling lower prices in future.

Thus frequent Openreach price reductions, or the practice of 'trailing' them with their wholesale customers and in the public media, has had a paralysing effect on the market, creating enough uncertainty that ISPs do not ultimately engage with altnets, to the detriment of long term competition.

Not only does this uncertainty affect the businesses of altnets directly, it also damages them by further adding to their funding challenges. Altnet business cases often include a forecast of wholesale penetration, pricing and revenue. Openreach pricing is obviously fundamental to those forecasts. In G.Network's case, ✂.

Therefore, in the long term interests of consumers, Ofcom could usefully seek greater certainty from Openreach in its pricing (at least as regards further decreases), impose the disciplines we perceive to be embedded in regulatory requirements to consult, and discourage trailing of potential reductions or other steps that might muddy the waters.

Ofcom has already taken steps to encourage greater clarity from Openreach regarding its deployment plans, recognising that uncertainty here damages the prospects for investment by the altnets. Pricing uncertainty is a parallel case, and could equally benefit from greater clarity.

Matters to consider

To summarise, we would respectfully offer the following reflections for Ofcom's consideration.

- The context of cost and availability of capital is radically different from that prevailing at the time of Ofcom's WFTMR decisions. We would suggest that Ofcom re-examine the question of whether Openreach's wholesale prices are sufficient to allow viable new entry.
- Pricing uncertainty caused by Openreach's price changes, and prevalent rumours about them, paralyse progress in the wholesale market. We would suggest that Ofcom requires that Openreach faithfully abides by the price consultation regulations; that is to say, Openreach should not be allowed to offer price changes to customers before publicly consulting on them.
- The wholesale market needs pricing stability to allow effective entry. We would suggest that Ofcom requires that Equinox 2 should be the last price changes in the FTTP wholesale market Openreach can offer before Ofcom's next review of the market.

Conclusion

As Ofcom put it in the WFTMR:

> "[The Strategic Review of Digital Communications] set out our intention to regulate to encourage large-scale deployment of new full-fibre networks both to homes and businesses, drive widespread availability of competing ultrafast broadband services and support the roll out of 5G networks.
>
> "We think the best way to achieve this and deliver these outcomes for consumers is through sustained support for competition in gigabit-capable networks in as many areas of the UK as possible."[14]

The altnets and their investors have answered Ofcom's call, and are investing substantially to deliver network-based competition. But the need for sustained support for this competition is if anything greater now than it was at the time of the publication of the WFTMR.

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[14] ¶2.7 onwards. Ofcom, *Promoting competition and investment in fibre networks: Wholesale Fixed Telecoms Market Review 2021-26. Volume 1: Overview, summary and structure*, 18 March 2021

Kevin Murphy
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Cc: David Clarkson