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Equinox 2 Consultation
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Hyperoptic Response: Ofcom Consultation – Openreach Proposed FTTP Offer starting 1 April 2023 (Equinox 2)

Introduction

Hyperoptic welcomes the opportunity to respond to Ofcom's consultation regarding Openreach's proposed FTTP offer, scheduled to commence from 1 April 2023 (Equinox 2). As established through the Wholesale Fixed Telecoms Market Review (WFTMR), Openreach is obliged to notify Ofcom of commercial terms where the price or other contractual conditions are conditional on the volume and/or range of services purchased. This process allows Ofcom and industry to consider whether Ofcom should intervene to prevent the implementation of the proposed commercial offer, on the grounds that such an offer may act as a material barrier to take up of alternative network operator services.

In response, Hyperoptic supports Ofcom's conclusion that it should not take any action to prevent the commercial terms of Equinox 2 being offered. This is because we believe that the Equinox 2 offer does not present a material barrier to access seeker take up of alternative network operator services.

Further, Hyperoptic welcomes Ofcom's decision to consider whether the discounted price model presented within the Equinox 2 offer reduces pricing to the point that a reasonably efficient operator competing against Openreach in Area 2 could not recover its efficiently incurred costs and so profitably compete against Openreach's average FTTP price under Equinox 2.

Whilst we acknowledge that this question is beyond the specific remit of the assessment framework in place to consider Openreach pricing offers that are conditional on the volume and/or range purchased, Openreach has both incentive and capability (as identified through its designation of Significant Market Power (SMP)) to undermine competition in this way.

Should Openreach pricing then be discounted to levels that undermine a competitor's ability to profitably compete in Area 2, it would inevitably impact an access seeker's material commercial incentives to explore using other network operators, as well as competitor network operator market entry and expansion more broadly. Given this link, Ofcom is right to use its response to Equinox 2 to elaborate on how it would assess further discounted Openreach wholesale pricing.

Ofcom's consideration of this risk is further supported by the scale of discount presented in Equinox 2. At both the 55, 80 and 115 price points, the Equinox 2 offer breaches both the FTTP 40/10 anchor price point and, critically, the upper end of the reasonably efficient operator (REO) cost range established in the WFTMR.

In Ofcom's Equinox 1 assessment, it placed significant weight on the proposed discounts not breaching the FTTP 40/10 anchor price point as part of its decision to not intervene. In addition, the WFTMR established a price range that a reasonably efficient operator competing in Area 2 would need to charge in order to recover costs and compete profitably. Both thresholds then

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prompt consideration as to whether their breach should compel Ofcom investigation outside of the 90 day notification process.

Regarding the FTTP 40/10 price, whilst we recognise Openreach's previous reference to this threshold in it's Equinox 1 decision, we support Ofcom's conclusion that breach of this price point is not the appropriate test. This is because the FTTP 40/10 anchor price point is not designed to be a price floor remedy. Intervening to deny the implementation of the offer on this basis would be procedurally inaccurate and unlikely to withstand appeal (despite Ofcom's references to the FTTP 40/10 price point in the Equinox 1 decision).

Rather, the correct test to apply is whether Openreach's pricing begins to fall below the upper end of the REO cost range established in the WFTMR. On this point, we support Ofcom's analysis that Openreach's average price across its portfolio of FTTP products does not, under the Equinox 2 offer, breach the upper end of the REO cost range.

Whilst we then support Ofcom's conclusion that it does not at this time have prima facie concerns that would lead it to further investigate whether Openreach pricing would inhibit Area 2 competitor cost recovery at this time, we propose that in light of Openreach's SMP, incentive and capability to seek to inhibit competitor entry and expansion, that it is appropriate for Ofcom to set out how it would act should Openreach propose pricing that would see its average price across its portfolio of FTTP products fall within the REO cost range.

Such a position would give reassurance to investors that there are procedural barriers to Openreach reducing wholesale pricing to the point that an Area 2 competitor can recover costs. As Ofcom itself acknowledges, questions of price level are outside the specific remit of the analysis framework in question. There is then a concern that, absence a regulated price floor, Openreach could implement a price reduction of this scale before Ofcom could investigate and intervene. Given Openreach's SMP, incentive, capability and track record in driving down its FTTP wholesale charges, we consider such an appropriate to be both appropriate and proportionate to the risk presented.

To do this, we propose that where Openreach's average price across its portfolio of FTTP products breaches the upper end of the REO range, Ofcom commit to investigating whether this price reduction undermines Area 2 competitor cost recovery. Further, where Openreach's average price across its portfolio of FTTP products breaches the middle point of the REO range, Ofcom implement an immediate interim remedy that pauses implementation of the offer, whilst Ofcom investigates whether this price reduction undermines Area 2 competitor cost recovery.

Background

Founded in 2011, Hyperoptic is a 'Fibre to the Premises' (FTTP) network provider, with a vertically integrated Internet Service Provider (ISP) function. Our business model focuses on the delivery of gigabit capable, FTTP connectivity in dense urban environments.

At the time of this submission, our network passes c1.2 million premises and serves over 275,000 customers, the vast majority of which falls within 'Area 2' as defined within the WFTMR. By consumer revenue and customers served, this positions Hyperoptic as the UK's largest 'alt-net'.

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Question 1: Do you agree with our assessment of the Equinox 2 Offer as set out above?

Summary Answer

Yes, Hyperoptic supports the conclusions that Ofcom arrives at in assessing the Equinox 2 offer. In coming to this position, Hyperoptic accepts that Ofcom must navigate between conflicting policy drivers in respect of promoting competition whilst also allowing Openreach to react to competition in a legitimate manner.

Given Openreach's designation of having SMP in the WFTMR, it is critical that Ofcom both scrutinise and consult on Openreach's proposed price reductions set out in Equinox 2, to ensure that Openreach is competing within the bounds permitted under regulation; specifically, whether the volume conditionality within the offer presents a material barrier to access seeker take up of alternative network operators. On balance, we believe that in this instance, the Equinox 2 price reductions should be permitted, and that Ofcom has reached the correct outcome in not taking further action to prevent the new terms from being introduced.

In arriving at this position, we consider the proposed failsafe mechanism to be critical to addressing any potential concerns regarding loyalty inducing impediments to access seekers considering the use of alternative networks.

This is done through allowing access seekers to carve out where they utilise alternative networks from the calculation that establishes qualification and scale of the proposed discount, thereby mitigating any commercial trade off in discount that an access seeker may need to consider against choosing to use an alternative network.

Indeed, the mitigation that the failsafe mechanism provides is so critical, that it is of concern that Openreach reserves the ability to withdraw it at any time. Ofcom must then ensure that any pause or limitation on the operation of the failsafe mechanism prompts a re-evaluation of whether to prohibit the Equinox 2 offer.

Further, whilst the mitigating function that the failsafe mechanism provides is of critical importance, it is only relevant to where an alternative network operator has already delivered service.

It does not address the wider loyalty inducing element of low pricing to access seekers; whereby Openreach may drive down wholesale pricing to a point that alternative network operators cannot recover costs. In such a scenario, access seekers face strong commercial incentives to remain 'loyal' to Openreach incumbency.

We then welcome Ofcom's wider consideration of pricing in this consultation, despite the matter of pricing's impact on competition being a procedurally separate question to that of whether the volume criteria within the Equinox 2 offer deters access seeker take up of alternative networks.

On the point of pricing more generally, whilst we acknowledge that elements of the Equinox 2 discounts breach both the 40/10 anchor price point and the upper range of the REO cost range established in the WFTMR for a competitor in Area 2, we support Ofcom's conclusion that the Equinox 2 discounts do not warrant further investigation is justified at this point.

In arriving at this conclusion, we consider how the failsafe mechanism, the FTTP 40/10 anchor and REO cost range are relevant to Ofcom's decision-making framework.

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Analytical Framework

To inform an analysis of Ofcom's assessment of Equinox 2, it is helpful to clarify the precise analytical framework that is to be applied to the offer.

In the WFTMR, Ofcom states that its "objective is to promote investment in gigabit-capable networks by Openreach and other operators in order to promote network-based competition"[1]. Ofcom goes further, and states that "[its] key concern is commercial terms that could undermine investor confidence in new network build and impact rollout plans e.g. by discouraging access seekers from switching demand to alternative networks."[2]

With this principle established, Ofcom draws a procedural line, stating that it is then 'appropriate' that the analytical framework it builds to consider such proposed terms, concern itself with "the promotion of competition rather than the protection of competition as under competition law".[3]

The starting point of this framework is that the creation of any barrier to using alternative network operators would only be justified where:

a) the impact on nascent network competitors is unlikely to be material; and

b) the arrangements will generate clear and demonstrable benefits, such as:

i) the arrangements are essential to Openreach's business case for fibre roll-out; or

ii) the arrangements are necessary to offer more efficient prices that would deliver benefits for consumers. [4]

To summarise what this framework establishes, Ofcom states that "commercial terms that have a material detrimental impact on competitive network build are unlikely to justified [and that...] where the commercial terms constitute some barrier to access seekers using new alternative networks, but the effect is unlikely to be material, we will consider the purpose and potential benefits of the terms."[5]

Effectively then, the key element of the assessment is whether there is a potential barrier to an access seeker using an alternative network operator. If there is, it needs to be objectively justified, in line with the above criteria, in order to be permitted.

Failsafe mechanism and loyalty inducing benefits

We consider the failsafe mechanism to be a critical point of mitigation to the risk of the Equinox 2 offer presenting a barrier to an access seeker using an alternative network operator. Fully implemented, we understand it to effectively remove the risk of ISPs being disincentivised from

[1] WFTMR statement, 18 March 2021, Volume 3, paragraph 1.7

[2] WFTMR statement, 18 March 2021, Volume 3, paragraph 1.759

[3] WFTMR statement, 18 March 2021, Volume 3, paragraphs 7.159

[4] WFTMR statement, 18 March 2021, Volume 3, paragraphs 7.154 and 7.160.

[5] WFTMR statement, 18 March 2021, Volume 3, paragraphs 7.160.

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placing orders with alternative networks, for fear of failing to meet the required OMTs to maximise discounting. It does this through allowing ISPs to have their performance against the OMTs assessed outside of any overlapping areas with an alternative network operator's footprint that the ISP also uses. In effect, the mechanism mitigates the risk of the Equinox 2 offer presenting a barrier to access seeker take up of alternative network operators to the point that criteria A of the analytical framework is met; i.e. that the impact on nascent network competitors is unlikely to be material.

However, this assessment only stands if the mechanism is both workable and maintained.

On the 'workable' criteria, we consider contractual commitment to a genuinely Independent Verifier to be fundamental to meeting this requirement. Without this, the precise parameters of the 'overlap area' would be open to gaming, which could be readily exploited by Openreach through leveraging its position of SMP.

As for 'maintained', we support Ofcom's concern that the mechanism can be modified or removed through the operation of 'legacy cross-check'. We agree that it is plausible that an access seeker's natural variation in legacy sales could result in failing the legacy cross check, and so risk deterring access seekers from either using the mechanism or accepting its use in a smaller geographic area than it otherwise would. This would undermine the mitigating effect that the mechanism provides, and so also fail Question A under the analytical framework. To that end, we welcome Ofcom's consideration of the risk of this occurring and position that any such amendment or removal to the Equinox 2 Offer concerning the failsafe mechanism would be required to be notified to Ofcom under the 90 days notification requirement.

With that said, the failsafe mechanism is only a point of mitigation to take up of an alternative network operator's <u>current</u> footprint. It does nothing to address the risk that wider price reductions could drive loyalty benefits for access seekers, and consequently reduce take up of alternative network operators and such operators ability to secure investment.

Whilst we then acknowledge that expanding consideration of pricing is beyond the specific scope of the analytical framework, it is directly relevant to Ofcom's initial starting point in building the framework, that being to promote investment in gigabit-capable networks by Openreach and other operators in order to promote network-based competition.[6]

It is then appropriate for Ofcom to expand its consideration within this consultation to assess the scale of discount and concerns regarding the implications this has for sustainable competition. We welcome Ofcom doing this, as it has historically when it considered the 'Equinox 1' discounts and their relation to both the FTTP 40/10 anchor price and the REO range.

Equinox 1 and the FTTP 40/10 anchor

The 40/10 price anchor is relevant to any consideration of Openreach discounting due to Ofcom's previous consideration of it as a proxy for the point at which Ofcom may have concerns regarding the price level inhibiting a competitor to recover efficiently incurred costs in Area 2. Specifically, in the Equinox 1 Statement, Ofcom used the above assessment framework to reach the view that no

[6] WFTMR statement, 18 March 2021, Volume 3, paragraph 1.759

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action was necessitated by the Equinox 1 offer. In doing so, it justified its decision, in part, with reference to the 40/10 anchor point not being breached.

Within the Equinox 1 decision, Ofcom states that "when setting the price ceiling for the FTTP 40/10 anchor product, we compared it with our estimate of the price that an entrant operator would need to charge in order to recover its efficiently incurred costs".[7] Further, that as "the price for the FTTP 40/10 anchor product is set at the regulated price ceiling, i.e. it is not discounted [and that] all other FTTP rental prices under the Equinox Offer are set at a level above this … 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.".[8]

On an initial reading then, Ofcom's Equinox 1 decision establishes a pricing line that is then breached by the proposed prices in Equinox 2, that being the FTTP 40/10 anchor. To be precise, the 55, 80 and 115 price points within Equinox 2 all fall below the £16.08 of the FTTP 40/10 anchor from April 1 2023.

However, we accept that this is not the appropriate test to apply. The FTTP 40/10 anchor was not designed as a regulated price floor. Rather, the relevant question is whether discounting undermines reasonably efficient competitor cost recovery in Area 2.

The price such a competitor would need to charge to recover such costs was considered within the WFTMR, and so provides the appropriate point of comparison when assessing Openreach discounting.

REO range

In light of Ofcom's previous consideration of the risk of Openreach pricing being discounted to the point of undermining an alternative network operator's ability to recover its efficiently incurred costs in Area 2, we welcome Ofcom consideration of the Equinox 2 prices in comparison to the REO cost range.[9]

The REO was introduced in the WFTMR in the context of considering whether pricing continuity would give less support to new entrants if the prices that resulted were significantly below the new entrants' costs. The REO range was then an output from Ofcom's bottom-up fibre cost model and allowed Ofcom to estimate that the unit cost of supplying FTTP services for a competing network operator ranges between £9.53 and £13.67.

Ofcom used the REO to then assess whether maintaining FTTC 40/10 prices at their (then) current level would sit within their own estimates of the range necessary to allow a competing network operator to profitably offer a range of FTTP services in the market.[10]

[7] Equinox 1 Decision, 30 September 2021, paragraph 3.43
[8] Equinox 1 Decision, 30 September 2021, paragraph 3.44
[9] WFTMR statement, 18 March 2021, Volume 4, paragraph 1.37
[10] ibid paragraphs 1.36-1.37

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In the current consultation Ofcom have indexed the REO to express it in 2023/24 prices, so that appropriate comparison can be drawn the prices set out in the Equinox 2 Offer. Reflecting in 2023/24 pricing, the range becomes £11.10-£15.93.[11]

With this range established, we agree that the relevant question to ask regarding Openreach discount pricing impact on competition, is the extent to which alternative networks in Area 2 could profitably compete against Openreach's average FTTP price under the Equinox 2 Offer. Whilst we acknowledge that individual price points within the Equinox 2 offer fall under the top end of the REO range, we consider that the use of estimated volumes based on key ISP customers, together with an average price across Openreach's portfolio of FTTP products, is a pragmatic and sensible measure.

We then support Ofcom's conclusion, that as the average FFTP price weighted by ISP forecasting under Equinox 2 is above the top end of the estimated range for the unit cost of an efficient FTTP entrant in Area 2, no further action is required at this time.

Again, we welcome this additional consideration even though it is not the primary gate-keeping question of the overall assessment. However, we believe that it is a critical consideration to any Openreach discount model that speaks directly to the core principle Ofcom set out when introducing the analytical framework in WFTMR, that being that Ofcom's "key concern is commercial terms that could undermine investor confidence in new network build and impact rollout plans."[12]

We welcome Ofcom turning its attention to engaging with the risk of Openreach discounting undermining the ability of alternative networks to recover their efficiently incurred costs. It signals to investors that Ofcom is alert to the risk of Openreach using wholesale pricing structures to reduce the returns available to investors in new fibre networks and undermine their further investment incentives.

Further, the logical consequence of Openreach pricing falling within the REO, is the greater the level of margin squeeze upon business cases relating to new network build and rollout in the higher cost areas of Area 2. The impact of this would be the descoping of future build plans for areas that are no longer commercially viable, as there is reduced scope for recovering efficiently incurred costs.

Given that Openreach's average FTTP price under Equinox 2 is above the estimated efficient entrant operator cost range, we then support Ofcom's conclusion that there is no prime facie need to investigate further at this stage. However, given the trajectory of pricing and Openreach's capability and incentives to use wholesale pricing structures to reduce competitor returns, it is appropriate that Ofcom elaborates further on how a 'bright line' test would be applied to protect against this.

We have set out our views on this point and offer a proposal in our response to Question 2.

We note that in addition to the REO range, Ofcom also considers how Openreach pricing compares to that of other alternative networks. We caution against this approach. Given Openreach's SMP, many network operators will be forced to price at or below Openreach's

[11] Equinox 2 Consultation, 3 February 2023, Table A10.1
[12] WFTMR statement, 18 March 2021, Volume 3, paragraph 1.759

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wholesale rates if they are attempting to attract the same access seekers. The desire to secure such access seeker demand may well prompt pricing that may not be sustainable if maintained into the medium term and/or a specific level of penetration required that may not materialise. Ofcom's 'cost up' model and REO range, established in the WFTMR, is then a better reflection of the point at which Ofcom should be alive to discounting to a level that undermines sustainable competition.

Question 2: Do you have any other comments on the matters set out in this document? Please provide evidence in support of your views.

Brightening the line

Whilst Ofcom state that a comparison of proposed Openreach pricing to the REO is not a 'bright line test', we believe that it is both appropriate and proportionate for Ofcom to 'brighten the line'.

In arriving at its conclusion to not intervene on the basis of Equinox 2 pricing to the REO range, Ofcom do not specifically set out what action they will take in the event that Openreach proposes that its average FTTP price reaches, or falls below, the upper end of the range.

The consequences of such a price reduction are severe. Building on Ofcom's use of the REO range, were Openreach's average FTTP price to drop below the top of the range, it would mean that pricing is falling to a level at which the ability of an alternative network operator to recover its efficiently incurred costs would be threatened. Particularly so for those that build in the higher cost areas of Area 2. The deeper into the REO range that the Openreach wholesale average price point is then proposed to drop, the greater the impact on competitor cost recovery.

As Ofcom then consider where Openreach pricing sits relative to the range, investors will then also take a similar view regarding where Openreach's average FTTP price sits relative to the alternative network's unit costs. Proposed Openreach pricing discounts will then directly impact on what constitutes viable investment. This change in the rate of return speaks directly to viability of investing in network build, with those premises at the edge of Area 2 / Area 3 most likely to see the most pressure. The cumulative impact of this would be the descoping of future build plans to remove such areas, as they would no longer be commercially viable.

Despite these concerns, Ofcom has been very clear (both in the current consultation and the Equinox 1 Statement) that the 90 days' notification requirement is not intended to address general concerns about discounted wholesale prices.

In reaching its conclusion about the level of pricing, Ofcom state that at this time they do not have prima facie concerns that would lead them to decide to investigate the level of the Equinox 2 prices in further detail. However, Ofcom do not say what would happen if they did have prima facie concerns about the level of pricing, other than to say that it would not be bound by the 90-day process. This lack of a clear 'trigger' is then concerning, as without it, there is no clear protection for alternative network operators to raise concerns against such reductions, beyond raising their own competition complaint. Such a measure is costly and a process that can take several years to complete, by which time, the detriment to competition risks being irreversible.

We therefore ask Ofcom to consider setting out the process for how they would assess such a scenario, e.g. under an 'Equinox 3' offer. We also offer a proposal for how this might be done.

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Proposal

Our proposal has two stages to it, to account for variation in the risk of detriment to competition. Where the Openreach average price across its portfolio of FTTP products falls below the estimated efficient entrant operator cost range, we propose that this should automatically prompt prima facie concerns that prices may be set at a level that prevents material and sustainable competition to Openreach in Area 2. Consequently, this should lead to one of either of the below options, dependent upon the scale of the discount:

a) Investigation

b) Immediate interim remedy followed by investigation

On a) – Where an proposed Openreach discount will, based on current forecasting, result in the average FTTP price breaching the top of the REO range, we propose that this should automatically lead Ofcom to investigate in further detail.

This is consistent with Ofcom's preliminary conclusion, which establishes that Openreach's average FTTP price under Equinox 2 is above the estimated efficient entrant operator cost range as part of the reasoning given for deciding that the price does not raise prima facie concerns.[13]

Furthermore, as set out above, as the price dips to a point at which the ability of an alternative network to recover its efficiently incurred costs would be threatened, the viability of investing in network build attracts increased scrutiny. Given the lack of immediate remedy to stop such an Openreach price reduction, there is then a very real danger of such price signalling deterring investment in alternative network rollout.

A clear signal that Ofcom will immediately open an investigation, not depedant upon a competition complaint, is then both proportionate and appropriate to the risk to alternative network investment that such discounting would present. The knowledge that Ofcom will investigate where prices are proposed to drop into the REO cost range, will serve to bolster investor confidence, who would otherwise be uncertain as to Ofcom may respond in reaction to every Openreach discount proposal.

On b) – If the expected average FTTP price breaches the middle point of the REO range, Ofcom should use interim measures to prevent such a discount from being introduced. This allows Ofcom to investigate in further detail whilst ensuring that such a discount cannot be implemented until the investigation is completed.

As the estimated efficient entrant operator cost contains a reasonably wide range, our proposed interventions are weighted accordingly; a) does not seek an immediate interim remedy, whereas b) does. This is due to the increased scale of discount (and consequently higher potential threat to sustained competition) in scenario b).

As for at what level an immediate interim remedy is warranted, Ofcom would face the following considerations. The bottom of the REO cost range must be the level below which any alternative network operator cannot recover its efficiently incurred costs and therefore cannot compete in a material and sustainable way with Openreach. Therefore, to entertain allowing the average price to drop to that level without taking any action will remove the entire alternative network

[13] Equinox 2 Consultation, 3 February 2023, paragraph 3.125

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investment incentive. This is then clearly too low a bar. Whereas the top of the range is the point at which prima facie concerns may emerge, but the increment into the range could be deemed immaterial to competition.

In light of the above, we propose that the middle of the REO range is an appropriate point for an immediate interim remedy.

As a result of the 90 days' notification requirement not being intended to address general concerns about low wholesale prices, there is a real and present danger to investment, should further price reductions come forward, as there is (currently) no reassurance to investors that Ofcom can act before implementation.

From an investor perspective, were Ofcom to investigate a future proposed discount without having previously set out how they would react to discounts further into the REO range, the mere proposal of discounted prices will act to deter investment. This investor uncertainty would only be increased if the regulator considered that proposed prices were at a point where there was prima facie concern that they prevent material and sustainable competition to Openreach in Area 2, but failed to halt the implementation of prices whilst the investigation commenced.

Ofcom recognised this risk in WFTMR[14], where they established that there is a relatively small window of opportunity to encourage new network build. In doing so, Ofcom referenced the risk that Openreach could introduce commercial terms that deterred the ability of alternative network operators to secure funds from investors for their FTTP rollout plans. Whilst Ofcom could use their powers to direct Openreach to remove certain terms, Ofcom specifically recognised that this process would take time, and if the terms have already been introduced, it could create market disruption.

Given the above and in light of Openreach's SMP, incentive and capability to undermine competition, and its track record in proposing continued discounts to its wholesale FTTP product range, it is both proportionate and appropriate for Ofcom to set out both the procedure and 'brightened line' for assessing whether future Openreach wholesale price reductions risk undermining sustainable competition.

[14] WFTMR statement, 18 March 2021, Volume 3, paragraphs 7.56-7.60