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Executive Summary

This is Three's (Hutchison 3G UK Ltd) response to Ofcom's consultation 'Strengthening Openreach's strategic and operational independence', published on 26th July 2016. This response builds on the arguments made by Three in its response to Ofcom's Digital Communications Review ('DCR consultation') published in June 2015.

Three calls on Ofcom to act decisively and structurally separate Openreach from BT. This response explains that, in the past decade, Ofcom has already given many opportunities to BT to make equality of access to Openreach work. BT has failed to do so and has significantly under-invested in the UK's critical infrastructure. The time to give further opportunities to BT has now passed.

Openreach is at the centre of the UK's telecoms infrastructure. Nearly every broadband provider and all MNOs in the UK rely on access to the Openreach network to provide broadband services to homes and businesses or connect mobile base stations to their core networks.

In the past decade Ofcom's regulation has not been successful in delivering equal access to Openreach, nor has it created the right incentives for investment in the UK's infrastructure. Continued ownership of Openreach has enabled BT to maintain its stranglehold on the country's digital infrastructure. BT has repeatedly shown that it <u>will</u> act on its incentive to:

- discriminate against rivals in the provision of wholesale access to Openreach;
- 'sweat' its copper network and invest in content rights and other risky ventures rather than in the UK's national infrastructure; and
- refuse to supply passive access products (such as access to Openreach's ducts) to prevent competing fibre networks to emerge.

Ofcom must act now to lessen the country's dependence on BT. Ofcom's recent DCR Statement has signalled a strategic policy shift to encourage the deployment of rival Fibre-To The-Home (FTTH) networks as an alternative to BT's investment in copper-based technologies (such as G.fast and VDSL). This is an important first step. Opening up passive access to Openreach's ducts will lower the cost of deploying competing FTTH networks and may stimulate BT to step up its own investment in fibre. Ofcom has set out a long term ambition for Openreach to face competition from at least two other networks in respect of 40% of UK premises.

The next step is for Ofcom to tackle the other two problems set out above – endemic discrimination by BT and its under-investment in Openreach. Ofcom has proposed to legally separate BT to ensure that Openreach focuses on the interest of all users, not just BT. Ofcom believes that it would be disproportionate to force BT to divest Openreach "*without first giving BT an opportunity to make legal separation work".*[1] Ofcom's aim is to give Openreach the greatest degree of independence that is compatible with continued ownership by BT. Openreach would become a wholly owned subsidiary of BT Group with its own purpose, Board, assets and greater financial control within an agreed budget set by BT.

Three's view is that Ofcom must act now to structurally separate BT. Ofcom has already given many opportunities to BT to make equal access to Openreach work. Ofcom's 2005 Telecoms Review found that BT had been discriminating against downstream competitors for twenty years. Ofcom suggested that the arguments for and against Structural Separation were *"finely balanced"*, but eventually accepted legally-binding undertakings provided by BT. These included i) the formation of Openreach as a separate division (Functional Separation); and ii) an obligation on it to offer the same wholesale products on the same terms to BT and its rivals (Equivalence of Inputs). However, in 2005 Ofcom left the door open to Structural Separation:

"*For the separation issue to be finally laid to rest, it will be necessary to see real evidence of progress towards a regime which guarantees real equality of access. Only where all stakeholders see real evidence of this is it realistic to expect demands for break-up to subside … We would prefer a solution which delivered equality of access without the disruption and costs of BT's Structural Separation. However, should such an approach not deliver the results required of it, Structural Separation may in the long term be the only viable option*" (emphasis added).[2]

Eleven years on, BT has still not delivered real equality of access. Ofcom has concluded that BT continues to exploit its ownership of Openreach to make strategic decisions that favour BT's interests over those of rivals. Ofcom has also found that BT's investment in the UK's critical access infrastructure remains a concern.[3] Similarly, a recent Parliamentary report has noted that Ofcom's regulation "*has not been successful in holding Openreach to an adequate level of service, and it is an open question how effective overall it has been in stimulating investment in Openreach's infrastructure*".[4]

Ofcom's insistence in giving another chance to BT is testing the industry's patience in circumstances where Ofcom itself has recognised that BT has circumvented the regulatory

[1] http://stakeholders.ofcom.org.uk/binaries/consultations/strengthening-openreachs-independence/summary/condoc.pdf , paragraph 1.23
[2] http://stakeholders.ofcom.org.uk/binaries/consultations/telecoms_p2/summary/maincondoc.pdf , paragraph 5.27
[3] Consultation, paragraphs 3.12-3.15
[4] House of Commons, Culture, Media and Sports Committee, 2016. "*Establishing world-class connectivity throughout the UK".*

regime for decades and has earned £4bn in excess profits on its regulated services in the last decade alone.

Structural reform is now needed. The answer to these problems cannot be to impose further behavioural remedies and monitoring BT's behaviour, as Ofcom attempted back in 2005. Ofcom does not have a good track record in detecting BT's anti-competitive practices and should not overestimate its ability to do so in the future. Fundamentally, there is an inherent tension between Ofcom's goal of an independent Openreach and BT's ability to exert effective supervision and governance of a wholly owned subsidiary. Legal separation inevitably leaves plenty of room for BT to continue to discriminate in its favour.

Three's view is that Openreach will not behave like a truly independent company while BT continues to own and oversee it. The only way for Openreach to behave like a genuinely independent company is to actually become one. Structural Separation of BT is needed to eradicate BT's incentive to favour itself and ensure sufficient investment in the UK's digital infrastructure.

In the past decade Ofcom has given many opportunities to BT to make equality of access to Openreach work.

In its 2005 Strategic Review of Telecoms Ofcom considered the type of competition that could be achieved in fixed telecoms. Due to the existence of large fixed costs and scale economies, BT's access and backhaul network is an economic bottleneck that is too costly for rivals to replicate. In consequence, broadband providers and mobile operators in the UK depend on access to BT's network to provide services to customers.

For instance, BT has a large cost advantage over rivals in the provision of mobile backhaul. MNOs purchase leased lines to connect thousands of geographically dispersed sites to their core network, including in areas where BT's rivals have no network.[5] BT has already incurred the main costs of provision (digging and ducting), which are largely sunk, and does not face costs of obtaining way-leaves or land-owner permissions. BT is also able to exploit economies of scale and scope from aggregating traffic from multiple cell sites and services (such as backhaul, Local Loop Unbundling, etc).

In 2005 Ofcom considered the problem of discrimination by BT. Ofcom found that vertical integration provided BT with both the incentive and ability to leverage its market power in fixed access and backhaul and discriminate against downstream competitors buying its wholesale services. BT's rivals were frustrated by delays and inadequacies in the wholesale access products provided by BT. Ofcom noted that BT engaged in discriminatory conduct across a wide range of markets (including local loop unbundling, private partial circuits, carrier pre-select and bitstream access).

[5] The purchases these lines via MBNL, its joint venture with EE, who purchases the lines indirectly via a managed service supplied by BT Wholesale.

The consultation document included five case studies setting out specific examples of discrimination, concluding that:[6]

"*Those who rely on BT to provide such access have experienced twenty years of slow product development, inferior quality wholesale products, poor transactional processes and a general lack of transparency*."

As a solution to twenty years of endemic discrimination by BT, Ofcom chose a 'compromise' solution that preserved BT's ownership of the bottleneck assets but sought to remove its ability to engage in anti-competitive discrimination. Ofcom accepted legally binding undertakings from BT instead of a reference under the Enterprise Act 2002.[7] The two key elements of these Undertakings were Equivalence of Inputs (EoI) and the formation of an operationally distinct 'Access Services Division' (Functional Separation).

Functional Separation

BT agreed to constitute a distinct separate access services division ('ASD', which was subsequently known as Openreach) which would form part of BT Group but be functionally separate from it. The ASD assumed the control and operation of the physical network assets making up BT's local access and backhaul network, including all staff and management tiers required to manage these assets.[8] The ASD became responsible for BT's access infrastructure, including the copper network, the fibre or next generation access network as well as ducts, poles and other civil infrastructure.

In order to ensure that Openreach focussed on the interest of all users, BT proposed to reform its corporate structure and governance as follows:[9]

- The CEO of the ASD would report to the CEO of the BT Group, but would not be a member of the operating committee of the BT group;
- The ASD would have the freedom to operate within an operating plan and capital expenditure plan agreed annually with the BT Group;
- The ASD would provide separate financial and regulatory accounts from the rest of the BT Group;
- The management team of the ASD would be based in physically separate locations from the rest of the BT Group;

[6] Ofcom, *Strategic review of telecommunications (phase 2)* (consultation), November 2004, paragraph 1.19, http://stakeholders.ofcom.org.uk/binaries/consultations/telecoms_p2/summary/maincondoc.pdf.

[7] Ofcom, *Notice under Section 155(1) of the Enterprise Act 2002: Consultation on undertakings offered by British Telecommunications plc in lieu of a reference under Part 4 of the Enterprise Act 2002* (30 June 2005), paragraph 2.2 http://stakeholders.ofcom.org.uk/binaries/consultations/sec155/summary/sec155.pdf.

[8] Ofcom, *Notice under Section 155(1) of the Enterprise Act 2002: Consultation on undertakings offered by British Telecommunications plc in lieu of a reference under Part 4 of the Enterprise Act 2002* (30 June 2005), paragraph 2.5 http://stakeholders.ofcom.org.uk/binaries/consultations/sec155/summary/sec155.pdf.

[9] *Ibid*, paragraph 2.7 and Annex E.

- The remuneration of the ASD's personnel would be aligned with the performance of the ASD in future, and not with that of the BT Group.

Equivalence of Inputs (EoI)

Similarly, the EoI obligation required Openreach to supply wholesale access to BT's downstream competitors in the same way as to BT's own downstream divisions, with the same timescales, terms (including price and service levels) and processes. The aim was to ensure a level playing field between BT and its downstream competitors. Ofcom stated its belief that:

"*… equivalence of input delivers many advantages over equivalence of outcome [where BT is not obliged to use the product itself]. It generates better incentives to BT to improve the products it offers to its competitors, it increases transparency, it is easier to monitor compliance, and it would require less on-going intervention by Ofcom. It therefore offers greater potential to solve the problem of inequality of access in a sustainable fashion.*"[10]

BT has failed to make equality of access to Openreach work and has underinvested in the UK's critical infrastructure.

Eleven years on, BT has still not delivered real equality of access despite the Undertakings it voluntarily provided to Ofcom back in 2005. Both Ofcom's DCR consultation and the current consultation on Openreach reform conclude that the current regulatory set up has not delivered the desired outcomes, namely:

- Openreach continues to favour the interests of BT over those of BT's rivals;
- BT has under-invested in the UK's critical infrastructure;
- Openreach has delivered poor quality of service to its wholesale customers;
- BT has earned £4bn in excess profits on its regulated wholesale services.

Endemic discrimination by BT

Ofcom has found that the 2005 Undertakings have prevented BT from supplying inferior wholesale products to rivals, but have not limited BT's ability to discriminate when making key decisions that shape the network itself.

Three agrees with Ofcom that, despite the 2005 Undertakings, BT has been able to influence and determine strategic investment and operational decisions that favour its own retail businesses over the retail businesses of others. In particular, i) BT Group has retained control over Openreach's strategic decision-making; ii) BT does not consult sufficiently with all Openreach customers on new investments in the network; iii) Openreach's governance lacks independence from BT Group; and iv) Openreach does not have its own capability, independent of BT, in areas such as research and development.

[10] Ofcom, *Strategic review of telecommunications (phase 2)* (consultation document), November 2004, paragraph 6.13, http://stakeholders.ofcom.org.uk/binaries/consultations/telecoms_p2/summary/maincondoc.pdf.

However, Three disagrees with Ofcom's conclusion that BT's discrimination has been limited to strategic network investment and operational decisions. Three's response to Ofcom's DCR consultation pointed out, with examples, the pattern that we have observed over time. Three provided numerous examples of access discrimination including i) discounting the price of Openreach products that BT consumes proportionately more of than its competitors; ii) structuring prices in order to make it difficult for competitors to compete effectively or to offer the same level of quality as BT; iii) misallocating costs to increase the prices of all regulated services or to increase the price of regulated services consumed proportionally more by its rivals; and iv) favouring the development of new products consumed by its own downstream divisions or supply a better quality of service to itself.

Under-investment in the UK's critical network infrastructure

Similarly, Ofcom has noted serious concerns relating to BT's investment in the UK's infrastructure in general, and especially in the rollout of fibre to the premises (FTTP) technology.[11] The industry consensus is that the UK is not adequately investing in critical fixed infrastructure due to BT's stranglehold of the UK's access network.

BT has a clear incentive to 'sweat' its copper network and avoid stranding its copper assets by quickly deploying fibre networks. In 2009 BT announced its intention to deploy fibre-to-the-cabinet (FTTC) technology and since then it has been upgrading its existing copper network incrementally instead of deploying FTTP. The consequence is that, as Ofcom's DCR consultation has highlighted, the UK compares poorly with the majority of peer countries in the availability of ultrafast broadband, including based on FTTP. FTTP technology is currently available to just 2% of premises in the UK, compared to over 60% in world-leading countries.

There is also a wider concern that BT is under-investing in Openreach overall while it cross-subsidises riskier projects across the rest of the BT Group, such as bidding for sports rights. For instance, BT recently outbid Sky in the sale of exclusive rights to broadcast UEFA's Champions League in the UK until 2017/2018.

A recent Parliamentary Report has found that BT has failed to invest hundreds of millions of pounds every year in upgrading Openreach's infrastructure as a result of inadequate investment incentives.[12] As Three noted in its report to Ofcom's DCR consultation, Openreach has a lower cost of capital and is thus 'less risky' than the rest of the BT Group. The Parliamentary report has found that, in assessing investment projects, BT uses a 'hurdle rate' based on BT Group's cost of capital of 10.4%, whereas Ofcom estimates Openreach's cost of capital is 8.8%. By requiring a higher rate of return than Openreach's cost of capital, BT is acting on its incentive to under-invest in Openreach to the tune of hundreds of millions of pounds every year.

[11] Consultation, paragraph 3.15

[12] House of Commons, Culture, Media and Sports Committee. "*Establishing world-class connectivity throughout the UK*".

Poor quality of service provided to wholesale customers

In 2005 Ofcom hoped that the requirement on BT to use the same products and services as its rivals would encourage Openreach to improve the quality of service provided to all its customers. This was on the basis that any deficiencies would be felt by BT itself.

However, in its DCR statement Ofcom has found that Openreach has provided a poor quality of service to all wholesale providers, including BT. Ofcom has variously reported delays in new line installations, failure to meet targets to fix faults, frequently missed and changed installation appointments and increased fault rates. To address these problems Ofcom has had to impose quality of services standards for Openreach in its 2014 Fixed Access Market Review, and more recently in its 2016 Business Connectivity Markets Review.

Excess profits on regulated services

Openreach is the most profitable business in BT Group with 2015/16 revenue equivalent to 27% of total BT Group revenue. Openreach contributes £2.664bn in operating cash flow to the Group, reflecting the return it earns on its regulated assets.

Ofcom regulates the terms on which Openreach supplies its wholesale access products to rivals, including local loop unbundling (LLU) for standard broadband, wholesale line rental (WLR) for providers who want to offer fixed phone-line rental to their customers, wholesale broadband access (WBA) products sold by BT Wholesale in areas there is limited competition, and leased lines used for business connectivity purposes (BCMR).

In its DCR consultation Ofcom has acknowledged that over a nine year period up to 2013/2014 BT has earned £4bn in excess profits on its regulated services.[13] Ofcom considered that around two thirds of the estimated £4bn gap is due to policy choices made by Ofcom when setting charges (such as the use of glide paths) while the remaining third is due to BT's performance against the charge controls.

Ofcom must act now to structurally separate BT.

In summary, in 2005 Ofcom attempted to solve twenty years of endemic discrimination by BT. Ofcom overestimated the effectiveness of its remedies and its ability to detect and constrain BT's behaviour. Eleven years since, BT has yet to deliver real equality of access, and its continued ownership of Openreach has enabled it to under-invest in the UK's infrastructure.[14]

Three's view is that Ofcom needs to act decisively and structurally separate BT:

- Only Structural Separation will eradicate BT Openreach's incentives to discriminate. This would put an end to endemic discrimination by BT and address the cause of the problem rather than the symptom. BT has repeatedly shown that it will act on its incentive to discriminate. Any other model of separation is targeted at reducing BT's

[13] http://stakeholders.ofcom.org.uk/binaries/consultations/dcr_discussion/summary/digital-comms-review.pdf , paragraphs 4.51-4.70

[14] A structurally separate Openreach would continue to be regulated, so it is doubtful that this would resolve the current problems in relation to quality of service and excess profits.

ability to discriminate, leaving untouched the motivation, incentive and value that engaging in discriminatory behaviour presents to BT.

- Three also agrees with the conclusion of the Parliamentary Report cited above that it is very likely that Openreach would invest more in upgrading its infrastructure if it were a separate company, since it would not be competing with other Group businesses and would be freed from the Group hurdle rate on investment.

Ofcom has proposed instead to legally separate BT to ensure that Openreach focuses on the interest of all users, not just BT. Ofcom believes that it would be disproportionate to force BT to divest Openreach "*without first giving BT an opportunity to make legal separation work*".[15] Ofcom's aim is to give Openreach the greatest degree of independence that is compatible with continued ownership by BT.

In Ofcom's proposal Openreach would become a wholly owned subsidiary of BT Group with its own purpose, Board, assets and greater financial control within an agreed budget set by BT. The table below compares the key aspects of Ofcom's proposal, BT's proposal and the 10-point plan proposed by Sky, TalkTalk and Vodafone.

Figure 2: Simplified separation plan comparisons

	Ofcom's proposal	*BT's proposal*	*'10 point plan'*
Company status	Legally separate, with all relevant assets and employees	**Continues as a separate division of BT Group**	Legally separate, with all relevant assets and employees
Openreach board	Majority independent directors, and independent chair, but appointed by BT subject to Ofcom approval	Majority independent directors, and independent chair, but appointed by BT subject to Ofcom approval	**All directors independent of BT, appointed independently**
Reporting lines	CEO reports to Openreach board	**CEO reports to BT CEO and Openreach board**	CEO reports to Openreach board
Budgeting	BT-set 'financial envelope', autonomy within this	BT-set 'financial envelope', autonomy within this	**Complete autonomy**
Investment/product consultation	Wide consultation on major investments	Wide consultation on major investments	**Wide consultation on strategy, capex and product design**
Branding	Independent branding, no reference to BT	**No change** (independent brand as a sub-brand of BT)	Independent branding, no reference to BT
Information sharing	Confidential stage within consultations	Confidential stage within consultations	**All information disclosed equivalently**

Note: Differences to Ofcom's plan are shown in bold
[Source: Enders Analysis based on Ofcom, BT and others]

[15] http://stakeholders.ofcom.org.uk/binaries/consultations/strengthening-openreachs-independence/summary/condoc.pdf , paragraph 1.23

Three is concerned that Ofcom is taking the wrong course of action once again with its proposal to legally separate BT. The fundamental problem with Ofcom's proposal is that there is an inherent tension between Ofcom's goal of a truly independent Openreach and BT's need to exert effective supervision and corporate governance of a wholly owned subsidiary. BT Group would need to approve major investment and operational decisions and will retain the ability to monitor Openreach's performance and intervene to protect its commercial interests.

At the end of the day, under Ofcom's proposal BT Group would i) continue to be the sole shareholder of Openreach; ii) control the composition of the Openreach Board (by appointing and removing members of the Board, albeit with Ofcom's approval) and iii) retain oversight of Openreach performance and control over its budget (through a financial envelope initially set by BT Group and with all proposals for increased spending subject to BT's approval). These provisions leave plenty of scope for BT to continue to discriminate in its favour.

Ofcom presents its proposed Legal Separation of BT as a key "*structural solution"* that is more likely to be effective than "*complex behavioural rules"* that simply seek to reduce BT's ability from acting anti-competitively.[16]

But this mischaracterises Ofcom's proposal. In 2005 Ofcom already attempted to reform BT's corporate structure and governance, as set out above. In reality Ofcom is proposing further behavioural remedies on BT, as it did back in 2005. Ofcom's proposal does not remove BT's incentive to discriminate. With a truly structural solution there would be no need for Ofcom to monitor BT's behaviour, publish compliance reports every six months or determine whether Openreach Board decisions are taken without undue influence from BT Group, as Ofcom is proposing to do. There would be no need to seek evidence from customers on the responsiveness of Openreach either.

Ofcom is erroneously assuming, as it did in 2005, that it will be able to detect BT's attempts to discriminate by monitoring of BT's behaviour. But Ofcom does not have a good track record in that role, as set out in the previous section. Ofcom must realise that Openreach will not behave like a truly independent company while BT continues to own and oversee it. The only way for Openreach to behave like a genuinely independent company is to actually become one.

[16] Paragraph 4.4