

## CERTAIN UNCERTAINTY:

# Ofcom's strategic review of digital communications

Ofcom published its much-anticipated Digital Communications Review (DCR) statement on 25th February 2016. The statement sets out Ofcom's initial findings across a range of issues facing the UK digital communications sectors, laying the groundwork for Ofcom's approach to promoting investment as well as its plans to empower and protect consumers. FTI Consulting's telecoms regulatory advisory team takes a first look at Ofcom's statement, reviewing the key proposals and highlighting the challenges that lie ahead for the sector.

The purpose of Ofcom's ten-yearly strategic reviews is to consult a wide range of stakeholders with a view to informing Ofcom's approach to regulating UK telecommunications markets in the coming decade. It was always going to be challenging for such a wide-ranging, long term, consultation to deliver concrete and specific action plans. Nevertheless a sense of anticipation had built up as to the direction that Ofcom may take in key areas.

**FTI Consulting's telecoms regulatory advisory team takes a first look at Ofcom's Digital Communications Review statement, and finds ideas aplenty but less in the way of concrete proposals or firm timelines.**

On the key issue of the future of Openreach, Ofcom has taken a middle ground and granted Openreach a stay of execution. Rather than pushing for the most extreme interventions, it is calling for enhanced functional separation, rather than structural separation. Here, Ofcom is effectively inviting BT to present a revised set of Undertakings, with the threat of structural separation waiting in the wings if it considers necessary.

Ofcom has also come out clearly in favour of fibre to the premises (FTTP) as the long term basis for an ultra-fast broadband Britain. It proposes to put in place measures to encourage investment in FTTP networks in order to provide infrastructure competition with Openreach and Virgin Media. Finally, Ofcom places a renewed emphasis on empowering consumers to take advantage of the technologies and services available to them, in turn creating more dynamic and competitive retail markets.

**As ever, the devil will be in the detail, and there is a great deal of detail still to thrash out.**

Ofcom's statement has six discrete but clearly interlinked strands:

- A strategic shift to large scale investment in FTTP;
- A step change in quality of service;
- Reforming Openreach;
- The right to broadband;
- Empowering consumers to make informed choices; and
- Deregulation where appropriate.

## A strategic shift to FTTP

Ofcom intends to create more choice for people and businesses, and reduce reliance on Openreach, by encouraging roll-out of FTTP networks as an alternative to BT's planned innovation in fibre/copper hybrid technologies (FTTC and G.Fast). Ofcom states that 'the best driver for investment and innovation is network-based competition: and this is at the heart of our future strategy. We believe competition between different networks (including those built from scratch or built using ducts and poles built by others) is the best way to drive investment in high quality, innovative services or consumers' (Ofcom Statement, paragraph 4.12 p35). In this regard, Ofcom believes that a good outcome would be to achieve network competition for around 40% of households.

### Enhancing duct and poles access

To support this objective, Openreach will be required to open up its passive infrastructure network, allowing easier access for rivals to deploy their own fibre cables along Openreach's telegraph poles and through its underground ducts. This remedy is being called duct and poles access (DPA) and the remedy being proposed is similar to that which has been used, for example, in Portugal, Spain and France and which is more widely referred to as physical infrastructure access (PIA).

Several respondents to Ofcom's consultation lobbied for enhancements to Openreach's existing PIA products. They argued that it was the quality of information provided about the assets and the process to get access as well as the price of access which had led to higher take-up rates in other countries. Ofcom has listened; its proposals focus on both price and non-price aspects of DPA. These proposals include:

- Requiring Openreach to price access in a way that encourages new build;
- The development of an online infrastructure database with location, capacity and condition information;
- Applying equivalence of inputs;
- Working with industry, Ofcom and the Office of the Adjudicator (OTA) to design efficient operational processes, and,
- Making DPA available to deliver business as well as residential services.

By doing this, Ofcom is looking to help competing operators to plan their network deployments with more certainty. However, the details of the DPA remedy will need to be worked through over the coming months in order to resolve important practical questions such as:

- Who pays for the network survey and process improvements?
- What happens when a duct is full, will there be an obligation on BT to increase the capacity of a duct route?

It is also far from certain that the DPA remedy alone will lead to a third network access operator emerging in the near future. Even with DPA at the heart of a supply-side solution, there are other important demand-side and market issues to be considered:

- Is there demand for the higher specification services that require fibre and are consumers willing to pay a premium for these? Ofcom has not sought to demonstrate that there will be demand; instead relying on historical trends of ever increasing demand for bandwidth.
- Even with DPA, there are high fixed costs associated with rolling out a fibre network. Is there space in the market for a third network such that it can meet the minimum efficient scale and compete with BT and Virgin Media? Is it more likely that a consortium player will enter the market, as has been seen in York, in order to achieve the meet the minimum volume threshold?
- Ofcom notes that competition is most likely to arise in urban areas. Does it foresee a new national operator focusing on urban areas or a series of regional players? Could future Universal Service Obligation (USO) funding mechanisms result in this operator being able to extend its footprint and compete in rural areas too?
- Ofcom has stayed silent on the question of the regulation of network oligopolies, a question currently being considered by the European Commission, and whether this new network operator (or Virgin Media as the second network operator) could find itself being required to provide regulated access to this network in the future.

Another question left unanswered is around the impact that the policy position on FTTP will have on BT. If the end game is now to achieve FTTP and in a quicker timeframe than was originally envisaged, will this change the regulation of BT? Ofcom notes that this may require a change in the basis of setting access prices to encourage entry, but will BT be permitted to switch off its legacy copper network sooner such that it does not need to bear the cost of running parallel networks in this new fibre world?

Finally, any discussion of Virgin Media and its planned fibre build is limited. What will the impact of DPA and potential new FTTP-based market entrants be on the Project Lightning roll out?

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## A step change in service quality

Ofcom identifies the service quality as the single biggest issue attracting comments during the consultation. Communication providers, consumer groups and individuals all reported dissatisfaction in this area, with the majority of complaints related to slow repairs and installations, missed appointments and poor customer service. The focus of Ofcom's analysis and likely interventions has been on Openreach, but the issues raised are wider and apply to the other fixed and mobile network operators and retailers.

The evidence on quality of service appears mixed. While an increase in the number of complaints has been registered over the last two to three years, other metrics have demonstrated operational improvements, such as a reduction in the number of faults reported to Openreach and the percentage of repairs that have been completed within the required time.

It could be argued that a key driver for the increase in complaints is increased sensitivity of consumers and businesses to service degradation when using high bandwidth streaming services. There may therefore be a need to consider QoS targets dynamically, taking into consideration how consumer perception is likely to change over time.

Ofcom proposes to drive service quality improvements through a combination of four measures:

- Using competition to drive quality of service improvements at both the network and retail level. Additional publication of quality of service indicators is seen as an enabler of competition;
- Set more demanding standards for Openreach, including increasing the scope of the current standards to new areas;
- Work with the industry to improve coordination; and
- Introducing automatic compensation for consumers.

One area that Ofcom will need to explore in more detail than is evidenced in its statement is the extent to which consumers are willing to pay for enhanced quality of service. Ofcom suggests that it 'see(s) opportunities for retail providers to differentiate their services but limited evidence that they do so today'.

There may therefore be value in Ofcom's proposal to use competition to drive quality of service, and it is important that consumers have the ability to adapt their behaviour if they are not happy with the service provided.

## Reforming Openreach

The future of Openreach has been the headline act when it comes to specialist and generalist media coverage of Ofcom's strategic review. Ofcom made it known even before the publication of its initial conclusions that the status quo would not stand. Yet there is little in the debate or in the positions adopted by the various stakeholders to the process that could be described as new.

The entrenched positions are the same, if perhaps that bit deeper dug and more reinforced. BT argues for the success of the current regime, and the disproportionality of further intervention. Many other communication providers argue that Openreach's position enables and incentivises it to act against the interest of BT's retail competitors, and that structural separation is required to release Openreach from the shackles of BT Group. Somewhere between the two entrenched positions sits Ofcom.

The functional separation of BT's access services division and the creation of Openreach was perhaps the most significant legacy of Ofcom's 2005 strategic review of telecommunications. The original intent was to limit the scope and incentive for discrimination, and to provide a behavioural reinforcement of the implementation of equivalence of inputs (Eol).

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Yet for all the investment in Eol systems, processes and products, and for all the constraints on BT imposed by the creation of Openreach, Ofcom concludes that the current model of functional separation fails fully to achieve its intended market outcomes.

As Ofcom recognises explicitly, Openreach's incentives in relation to efficiency, investment and quality of service are a function of the level of competition at the infrastructure level, not of the vertical integration of BT. For these reasons, compounded by the practical and financial issues that it also recognises, Ofcom focuses on strengthening the functional separation regime, keeping structural separation in its back pocket as a stick to BT along with.

What, then, does Ofcom want a stronger functional separation regime to deliver?

## Greater independence in strategic decision making

Ofcom suggests that the current governance structure continues to provide the scope and incentive for Openreach to discriminate in favour of the interests of BT Group. Specifically, Ofcom appears to argue that the roll out of FTTC and G.FAST technologies rather than FTTP is a result of a BT Group decision, and – by extension – that a more autonomous Openreach may have reached a different conclusion. To address this Ofcom proposes the creation of an Openreach Board with more independent governance within the current functional separation model.

## Enhanced autonomy

Ofcom cites two primary concerns; the first is that Openreach investment decisions over a £75m threshold can still be taken by BT Group under the terms of the 2005 Undertakings, and the second is that Openreach remains dependent on certain shared BT Group functions, particularly the Technology, Strategy and Operations division.

In relation to the first issue, Ofcom wants to see Openreach's Chief Executive being given more delegated authority to make investment decisions in the hope that this might lead to, for example, co-investment or risk sharing agreements with other operators. The second issue is even more challenging, and Ofcom doesn't make any proposals in regard to this; a key question for Ofcom to consider is whether the costs of standalone support functions in Openreach would be greater or less than the level of costs allocated to Openreach using the current regulatory accounting methodologies.

### Equality and consistency in consultation

Ofcom suggests that the decision to invest in FTTC was taken without sufficient, timely or transparent consultation with Openreach's downstream customers. Again, the argument is that there may have been different network investment outcomes had there been more extensive an open consultation.

As a result, and with a view to ensuring that all investment options and scenarios are fully considered, Ofcom is considering the imposition of undertakings to consult more openly with downstream operators on substantial investment and innovation decisions.

### Further restrictions on the allocation of shared costs

Ofcom maintains its current focus on prescribing the methodologies that BT uses to attribute costs between its various businesses. This clearly links to the broader question outlined above as to the level of cost that would be incurred by a more self-sustaining Openreach division. Ofcom's review of BT's cost attribution methodologies is subject to a separate ongoing consultation, our contributions to which can be viewed on Ofcom's own website.

The subtext to Ofcom's initial conclusions on Openreach is an invitation for BT to propose an enhanced set of Undertakings; however the inherent tension in Ofcom's position will remain. Ofcom's desired efficiency, investment and quality of service outcomes are dependent on infrastructure competition and not on the removal of vertical integration.

## The right to broadband

Ofcom's approach is informed, as it must be, by the UK Government's plan to make decent, affordable broadband a universal right for every home and business in the UK. Its challenge is to manage the process of establishing what is 'decent' and 'affordable' and to put in place strategies to deliver these.

With this in mind, Ofcom has set out plans to support the Government's aim of a 10Mb/s by:

- Enabling further investment in fixed networks;
- Exploring options for extending mobile coverage, in particular through the 700 MHz band;
- Supporting the Government's reform of the Electronic Communication Code; and,
- Providing consumers with accurate, comparable and accessible coverage information so that they can make better choices about the services they consume.

Ofcom faces several challenges in codifying these objectives and putting in place specific proposals to deliver them, including:

- 10Mb/s is just the starting point: Ofcom expects that the definition of the USO will need to evolve over time to ensure that consumers benefit as technologies and service improve. Ofcom has not specified over what timeframe this will evolve, which inevitably creates uncertainty for Openreach and other operators.
- Copper will continue to play a role in the USO: As Ofcom notes, current VDSL can deliver 9Mb/s over a 2km copper connection. BT has demonstrated that 'long-reach VDSL' can deliver 24Mb/s over the same distance. However, there are practical problems with long-reach VDSL as it may interfere with services delivered over LLU.
- New mobile spectrum will come with coverage obligations: Ofcom has said that the 700MHz spectrum will come with coverage obligations. It is not clear whether coverage obligations would apply to the whole 700MHz spectrum, or just a portion of it (as is the case for 800MHz). The 700MHz spectrum is not due to be made available until 2021 and will not be auctioned until 2018/2019.
- The USO need not be provided by Openreach: Ofcom has made clear that the USO provision could be provided by a range of technologies. It states that the intention of the USO is to build on existing networks, rather than displace them.

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## Empowering consumers

Ofcom is concerned that consumers do not have sufficient information to make fully informed choices, and that this constrains the level of retail competition. Ofcom identifies three policy pillars to help overcome this challenge.

### Dealing with overly complex pricing structures

Ofcom's research found that many customers were not able to calculate the total cost of broadband contracts correctly. In order to address this Ofcom is considering imposing a requirement for service providers to provide standardised pricing information. It will be interesting to see how Ofcom approaches this question of comparability.

Two areas in particular which it will be interesting to see Ofcom deal with are firstly how (if at all) to account for bundled services in price comparisons and secondly whether prices should be stated in terms of headline maximum available broadband speed, or actual average speed.

### Removing barriers to switching

Ofcom did not announce any new measures here, but indicated that it would be publishing proposals for mobile switching and switching triple-play service later this year.

It will be interesting to see how Ofcom decides to handle the inevitable trade-off between the negative 'hassle' of switching (which Ofcom identified as the major reason for customers not switching) and the reduced 'hassle' of having a single provider on one bill.

## Supporting vulnerable customers and consumer protection

Ofcom did not make any new announcements in these areas – rather it indicated that it plans to continue to monitor issues as they arise and intervene when necessary.

It is interesting to note that Ofcom's proposed QoS safe guards are focused at the wholesale, rather than retail, level which is what ultimately matters for consumers. One area we would therefore expect to see Ofcom consider further is how to ensure improvements in QoS at the wholesale level are passed down to retail customers.

## Scope for deregulation

Finally, Ofcom has reiterated its objective of stepping back from regulation where people and businesses no longer need it, including when there is a real prospect of competition. It notes the continued convergence of voice services delivered over fixed and mobile networks and the increasing availability of communications services delivered over the internet, known as OTT services, e.g. Skype, WhatsApp etc. However, given that some consumers choose not to use these services and remain dependent on traditional voice and messaging services it has decided that the corresponding OTT services are not in the same economic market as traditional telephony services. It concludes therefore that regulation of traditional services remains warranted at this time to protect this group. This is something that Ofcom will need to keep under constant review.

It is worth noting that several further questions remain unaddressed in Ofcom's statement:

- Ofcom has stayed silent on the question of multi-sided markets and has not looked in detail at market definition in this review. What evidence would Ofcom accept as sufficient to demonstrate that OTT services constrain traditional services to such a degree that deregulation could occur?
- Will the convergence and consolidation that is being observed in the UK telecommunications sector and an increasing propensity to compete on bundles of services change the competitive constraints in regulated markets?
- Does this approach place traditional telecoms operators at a disadvantage to the OTTs providers who are currently subject to less regulation?

## Conclusion

If there is one thing that all UK telecoms operators and their investors can agree on, it is the need for regulatory certainty. Ofcom's initial conclusions are unlikely to give investors much comfort as to the prospects of this happening in the near term. When set alongside the European Commission's proposals to revise the EU-wide telecoms regulatory framework as part of the Digital Single Market agenda, and there is much that remains uncertain. It is unclear, for example, how long Ofcom is giving itself to develop concrete proposals, or over what period it is prepared to assess the success of measures to strengthen the independence of Openreach. This uncertainty could result in a risk premium being added to network investment business cases and, potentially, a delay in investment as both existing network operators and those considering using DPA await more detailed proposals and to see how the land settles before committing significant investment.

Alberto Carpani  
+44 (0)20 3727 1064  
alberto.carpani@fticonsulting.com

Schellion Horn  
+44 (0)20 3727 1815  
schellion.horn@fticonsulting.com

Scott Morrison  
+44 (0)20 3727 1754  
scott.morrison@fticonsulting.com

Neil Clements  
+44 (0)20 3727 1080  
neil.clements@fticonsulting.com

Hugh Kelly  
+44 (0)20 3727 1285  
hugh.kelly@fticonsulting.com



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