Supplementary evidence submitted by BT to the Culture, Media and Sport Committee inquiry, Establishing world-class connectivity throughout the UK

The case for an integrated Openreach and Ofcom's initial conclusions from the Digital Communications Review

We are writing in response to your questions regarding:

1. Comments on the main points of Professor Helm's analysis (written submission of February 2016 and oral evidence of 2 March 2016), including the question what are BT's internal costs of capital for the various businesses within the BT Group?
2. What would have to be done to enable full separation and what would be the key challenges if a full separation of Openreach were to take place?
3. A reflection on Ofcom's principal findings in the context of our terms of reference for this inquiry.

We will take each of these in turn.

1. Professor Helm evidence/costs of capital

Professor Helm argues that the model of functional separation is wholly unsatisfactory for several main reasons, BT:

- has a serious and profound conflict of interest because it provides services through Openreach in competition with other users of its network
- has a deep interest in protecting the revenues from the existing copper wires
- finances a significant proportion of BT's historic pension liabilities through Openreach
- utilises some of the returns from Openreach to underpin its investments in competitive services and to support its dividends.

Professor Helm argues that BT has a serious and profound conflict of interest because it provides services through Openreach in competition with other users of its network.

This is not the case. BT invests in Openreach to meet end-customer needs and communications providers' (CPs') customer needs. It does so on the basis that all its investments in Openreach networks are available on equal terms to all CP customers, within the most stringent wholesale supply regulations in the world. No conflict of interest arises because all customers of Openreach, both BT's own retail operations and all third-party CPs, get equal access to these investments.

BT competes with Virgin Media in 45% of the country today and Virgin is extending its network to 60% of the country. Virgin has no wholesale supply obligations, despite the fact that it is the market leader in superfast broadband and benefits from making investments on the basis of 100% end-to-end margin made from its retail sales. BT invests in Openreach so that it can compete more effectively with Virgin. It does so hampered by the fact that it can recover its investments by 100% of the margins at the Openreach level and only about half the margins made at the retail level (the other half being made by third-party CPs). In other words, regulation has the adverse effect of inhibiting BT from making investments in competing with Virgin.

BT Group is subject to the functional separation of Openreach, imposed in 2005, under which Openreach is required to treat all of its customers (including the rest of BT) in exactly the same way. The very success of competition since 2005 bears out that this has been overwhelmingly successful.

Competition in the fixed-line part of the industry has flourished as a result of the functional separation of Openreach and access to its competition-ready network on an equivalent basis. Openreach supplies regulated products and services on an equivalent basis to over 500 CPs. International benchmarking shows that the UK has one of the most competitive broadband markets in the world. The UK retail market has seen the emergence of two of the top four broadband competitors, Sky and TalkTalk, from a base of zero subscribers before functional separation to supplying 40% of the market within 10 years. As a result of this competition, BT has the lowest retail broadband market share compared with European incumbents, at 32 per cent. This demonstrates that the UK is the most open and competitive market in Europe, no other European country can match this. There have been no cases of discriminatory behaviour impacting competition in the last 10 years.

BT does *not* do only what is best for BT Group rather than the industry as a whole. It is impossible for BT to act in this way, because all its Openreach investments must be made available to all CPs on equal terms. There is a process for CPs to request Openreach product developments for their own requirements. These are treated by Openreach in just the same way as are requests from BT, and Openreach has a proven track record of receiving, assessing and responding to requests submitted by CPs following the agreed industry process.

The compliance processes in the company, under the auspices of the Equality of Access Board, ensure compliance with the requirements to treat all customer requests fairly and has always found that Openreach has done so. There has only been one allegation to Ofcom that Openreach did not decide fairly on a statement of requirements from a CP and Ofcom found in Openreach's favour.

Sky also said to the CMS Committee in December 2015: "…we are not alleging that BT Retail is favoured by BT Openreach in the treatment of customers. That would be a step too far and it is not an allegation we would make."

The assertion that "No credible set of rules can overcome such a deep and profound conflict" is therefore completely flawed, unfounded in fact and flies in the face of the regulation.

Professor Helm also entirely ignores Virgin Media. Ofcom is quite clear in its recent report that this competition has been a spur to investment, with the availability of cable broadband whilst BT increased the performance of its initial broadband service in the early 2000s; that Virgin Media's upgrade to DOCSIS 3.0 and BT's rollout of superfast broadband coincided at the end of the decade; and Virgin Media now offering a maximum service speed of 200Mbit/s against BT's G.Fast investment plans. These benefits from competition have extended beyond cable areas as fibre has been rolled out so extensively. Openreach is *not* a monopoly, or a supplier of basic utility services that lacks the spur of competition.

One City broker[1] described the UK as representing the 'holy grail' of regulation, by persuading a large rival operator to BT to deploy infrastructure of its own; and that most European (or even global) regulators would be absolutely thrilled to replicate BT's levels of fibre coverage. To have, in addition, the cable operator expanding its coverage was described as being a "magnificent [regulatory] achievement."

Other suppliers are investing too, although not at the extent of Virgin Media and BT, and using different technologies. It is remarkable that Professor Helm makes no mention of infrastructure competition, equating Openreach to monopolies like the water and electricity companies.

[1] HSBC Telecoms, Media & Technology Equities – United Kingdom, 22 May 2015.

The second argument by Professor Helm that BT ought to be broken up because: "…it has a deep interest in protecting the revenues from the existing copper wires," is equally incorrect, if it is meant to imply that this is in some way some anti-competitive, or working against customer interests.

Of course all commercial enterprises wish to protect their revenues. In BT's case of course it wants to protect revenues from copper wires. However, BT has been more proactive in selling fibre-based services in the retail market than any of its competitors by a large margin, which is not, we would suggest, the action of an organisation seeking to preserve legacy copper revenues. On the contrary, BT proactively sold fibre broadband, priced it to sell in large volumes in the retail market and invested in branding and promotion to make that happen.

Indeed, for the conduct that indicates a retailer was more interested in preserving copper broadband, one has to look at the conduct and statements of LLU operators. Neither Sky nor TalkTalk chose to sell superfast broadband for some years after it first became available from Openreach, because they did not see the demand for it. Rather than BT protecting revenues from legacy technology, it was actually BT which pushed ahead with marketing fibre and demonstrating its benefits. Indeed, the accusation now is that we are being too successful with new technology and trying to dominate the market in fibre. One day the complaint is that BT is too slow; the next, that we are going too fast.

Third, it is not the case that BT utilises some of the returns from Openreach in an incorrect manner. Of course it "supports its dividends" as Openreach is one of the businesses shareholders own and on which they expect a return (and they would do so were Openreach separate). BT's Consumer division responsible for its sport investments, is highly profitable and cash-generative in its own right. Its business case for investing in sport has always been exclusively founded on returns made within the Consumer division. It remains profitable and indeed is more profitable and cash generative than before it made its investments. All the cost of competitive services such as sports rights are both accounted for in the retail business and funded by retail charges.

The fact that returns from Openreach contribute to the overall Group profits which themselves fund BT's historic pension liabilities cannot be contentious, as many of these liabilities arise from past Openreach employees. A separated Openreach would also need to cover any such liabilities. Such liabilities are also allowed as costs for other utilities, again implying that separation would make no difference.

The "several main reasons" Professor Helm suggests to the Committee are therefore all, in our view, simply wrong.

Investment and integration

The analogy that Professor Helm draws between Openreach and water and electricity also ignores key differences between telecommunications and the other utilities: telecommunications is a) a competitive sector and b) undergoing a tremendous period of positive disruption and innovation. Services which were unheard of just a few years ago are now being supplied to millions. Where there is innovation, integration is extremely beneficial for investment. When Openreach invests in new services it benefits from having BT as an 'anchor tenant', which will guarantee it a route to market and lessens the risk of making access investments.

A separated Openreach would be in the position of seeking to make business cases for investment without being able to rely on a major retailer to market its new services. As risk is costly, lower risk means investment can be higher, and services launched that would otherwise never reach end users.

The business case for fibre broadband investment was expected to achieve a payback on a BT Group basis of over 10 years when the investment decision was made; that is a very long payback period to tolerate by the standards of normal commercial organisations, but BT made that commitment nonetheless. However, the payback at the Openreach level was nearly 20 years, when the benefit of retail margins were taken out of the case. A payback of that length is very unlikely to have been supportable by a separate Openreach. But even a payback of 20 years would not have been achieved by an independent Openreach, given that it relied on a strategically committed retail partner. If BT's retailing operations had behaved as the other LLU-based retail CPs had done, and waited years before selling the Openreach product, the investments would never have achieved a payback for an independent Openreach.

Integration is therefore economically efficient. All major network telcos appreciate this which is why, whether fixed or mobile, throughout the world they are integrated. A fuller explanation of this was set out in our October 2015 response to the DCR, and supported by the relevant economic theory.

It is also a point which Ofcom recognises in advancing the case for continued common ownership: "For example, where Openreach did invest in new networks or services, the common ownership of the group may mean that BT's retail divisions continue to act as an 'anchor tenant' and market these services to customers. BT Group would have an incentive to make use of networks deployed by Openreach and therefore promote take-up of services delivered over these networks."

If separation were really likely to be shareholder enhancing, why do telcos throughout the world not decide to separate? In fact, only one company has volunteered to separate (in the Czech Republic) under very specific circumstances. We think our shareholders are best served by investing both in access network upgrades and in developing new services which we can market through our retail arms. This is the benefit of having an integrated structure and how it brings value to shareholders, new services to customers and, through equivalence of access, supports competition by making these services available to our competitors without any discrimination.

Openreach as a wholly-owned subsidiary

Professor Helm refers to a possible remedy proposed by Ofcom which involves Openreach becoming a wholly owned subsidiary within the BT Group, with full independence. We know of no model along these lines in the world, with the single exception of Singapore, where even that arrangement is only temporary. The whole model in Singapore was specifically designed to enable the government to direct the roll-out of fibre to the home, involving very large public funding. So it cannot be compared with the UK.

We can identify no benefits from incorporation. All the obligations on the directors would have to be imposed by regulation: embodying them in the governing documents of a subsidiary adds nothing to their force or their enforceability.

Under UK company law, it is very unlikely that such an arrangement would be permissible, indeed Ofcom adds: "We will also consider the need to reconcile increased independence for Openreach with the corporate governance responsibilities and legal duties of the main BT Board."

There are, however, potentially enormous costs from seeking to incorporate a business of Openreach's scale, if this is assumed to involve the transfer of people and assets, rights and obligation, contracts and costs into a new entity. We do not see how it can possibly be proportionate to impose such an obligation when the benefits are zero and the costs enormous.

Cost of capital

Professor Helm argues that a separate Openreach with a "utility structure" would deliver more investment at a low cost of capital. The Committee has also asked BT to share our internal costs of capital for the various businesses within the BT Group.

The reality is that, with regard to cost of capital, Openreach is treated as if it were separate anyway. No advantage would be gained in this respect from separation, as explained below.

Ofcom imposes its view of Openreach's cost of capital. It estimates the cost of capital using the same capital asset pricing model (CAPM) as used by other UK regulators. This estimates cost of capital based on the combined cost of debt and equity, based on the observed volatility in the share price. However, whilst Ofcom observes the *average* cost of funds to BT Group (using the CAPM) it then disaggregates this average into the estimated costs which apply to Openreach and to costs which apply to the "Rest of BT". The basis of the disaggregation is an assessment of the relevant riskiness, under the CAPM framework, of the two types of businesses: the lower risk part (most of Openreach) and the higher risk parts of BT. Thus, Openreach is only allowed a cost of capital in line with its specific (and lower) level of riskiness.

It follows that:

- were Openreach (or any part of Openreach) to be assessed as being no more risky than a pure utility, it would be allowed no more than a "utility" cost of capital
- there is no huge difference between what Openreach is allowed under this disaggregated approach and the result of a similar assessment into the cost of capital were Openreach to be separated. In effect, Openreach is *already* treated from a financial point of view as if it were separate.

Under the most recent concluded assessment for Openreach, made in 2014, Ofcom estimated that overall BT Group's nominal pre-tax cost of capital was 10.0%. This was then disaggregated into a utility cost of capital applying to Openreach of 8.6% and one for the "Rest of BT" at 10.8%.[2]

The Openreach allowance of 8.6% in pre-tax nominal terms when expressed in terms of real post-tax returns was 4%, below the level set for Heathrow, and very close to that allowed by Ofgem for the regulated electricity and gas companies. The cost of capital for Openreach is therefore no higher than for the pure utilities.

As the Committee might be aware, fibre broadband services themselves are not subject to price regulation. The reason here is straightforward, despite investing since 2009, Openreach won't achieve break-even until the early 2020s, using the Rest of BT cost of capital, and to date Ofcom has recognised that to regulate in such circumstances (especially as demand was uncertain at the time) is disproportionate. This matter is one which will be considered again by Ofcom in 2016/17, when Ofcom will consider the financial case, again using a prism of Openreach being a distinct business, so separation would make no difference.

Professor Helm suggests that BT borrows at its average cost of capital across all its activities, and this makes investing in "utility" infrastructure expensive. But the low-risk utility business underpins BT's credit rating and contributes to a lower average cost of capital, ie, it brings the average (of 10.0%) down. The marginal rate of borrowing for Openreach services is therefore a lower risk utility rate,

[2] In a June 2015 consultation, Ofcom set out proposals to make a three-way disaggregation of BT Group's cost of capital. The "utility" Openreach rate was assessed as having fallen marginally to 8.4%, with the Rest of BT rate increasing to 12.5%. The new, third category was for "Other regulated services" (mainly ethernet) for which the allowed rate of return was 10.1%. Ofcom has not issued a statement to conclude this consultation.

because of the impact in lowering the average cost, it is just that this cannot be seen directly. As described above, Ofcom in effect de-averages this single rate along these lines, and in this process shows the components. The "high-risk, entrepreneurial entry into TV and other services" does not therefore make infrastructure financing expensive - if it did, Ofcom's whole approach (which is common across the utility sector) would be wrong.

BT does not make its own estimates of the cost of capital, separate from its response to Ofcom when the issue is reviewed. The cost of capital is used to set regulated prices, whilst commercial factors determine what BT can earn in competitive, unregulated markets.

2. Tasks required for full separation and key challenges

Moving from functional separation to full separation would be a very significant undertaking. From our experience of functional separation in the years following 2005, we know it would take several more years to deliver full structural separation. The costs are likely to be substantial; those for functional separation are estimated to be in excess of £1bn. Further costs would ultimately fall on the heads of consumers, competitors, or those who have invested in BT, which could otherwise be used to invest in new services, such as fibre.

BT would have to focus on delivering separation of systems and processes and network assets; it is inevitable that there could not be the same focus on fibre roll-out to keep the UK in a world-leading position. Indeed, the complex changes required to meet the 2005 Undertakings' functional and equivalence obligations have taken nearly 10 years to complete.

BT set out the major challenges in the October response to the DCR, which are summarised below.

Systems. BT was created and has evolved on an integrated basis. There would need to be a very large exercise to establish the extent to which such systems and processes can be pulled apart and substituted by independent systems, and where this is not possible for technical reasons, to determine what should happen. There would be an impact on other communications providers (CPs), as their systems and processes would have to change to incorporate extra system releases that a separated Openreach would need to make.

People. There were 32,400 employees on average in Openreach during the last financial year. The requirements of the Transfer of Undertakings (Protection of Employment) Regulations would need to be addressed in relation to the transfer of BT employees to any new legal entity, as would other potential issues from an Employee Relations perspective.

BT Pension Scheme. This is the UK's largest private pension scheme by assets and was the 44th largest in the world at the 2014 year end, with over 300,000 members. Intervention that would impact the financial scale of BT plc materially and alter its business structure would present huge challenges for the Scheme, potentially impacting its ability to fund the pensions of Openreach employees.

The BT Pension Scheme has the benefit of a Crown guarantee, with the Government guaranteeing BT plc's obligations to the Scheme on BT plc's insolvency. This guarantee only relates to the obligations of BT plc in relation to the BT Pension Scheme and would not apply to another pension scheme run by a new legal entity (including within BT Group) subject to further discussions with the Government.

The Scheme's liabilities include those attributable to benefits accrued by BT plc employees whilst working within Openreach. If a new 'mirror image' pension scheme was set up by a new legal entity, the value of liabilities for which the new legal entity would become liable would need to be calculated as well as the proportion of assets within the BT Pension Scheme to be transferred to the new entity's pension scheme. Setting up a 'mirror image' scheme would be an extremely complex exercise, which could involve court proceedings, and is likely to take some years to resolve. It would also require the involvement of the BT Pension Scheme Trustee and likely also the Pensions Regulator.

Wayleaves. BT currently has in excess of two million wayleave agreements across the UK. These agreements are in the name of BT plc, and they are believed to be 'personal' to BT plc. They would need to be addressed individually so that the new legal entity had the necessary permissions to place infrastructure on, under, or over land, and any transfers or assignments where possible or permitted would be subject to the laws of the different UK jurisdictions. Resolving the wayleaves issues would be an exercise that would take several years to complete, with considerable costs and complexity.

Physical estate. BT's estate includes over 5,000 exchanges and hundreds of other buildings. Ownership of many of these has been transferred to Telereal under a sale and leaseback arrangement. An independent Openreach would need to take over many buildings. However, BT's arrangement with Telereal does not fully allow BT to assign its occupational leases of the properties. To achieve this it would require a renegotiation of the arrangements. This would be extremely complex and costly and result in BT being subject to high penalty charges. Any assignment of the BT occupational leases will have implications for associated sub-tenancy agreements entered into with CPs, which use exchanges for equipment or accommodation.

The ownership of each premises would need to be dealt with individually. Short cuts would not be possible: for example, exchange buildings may house Openreach network assets and non-Openreach core network assets (and they can include space rented by CPs). Each building would need to be properly surveyed and plans prepared to determine which parts would remain owned by BT and which would be transferred to the new legal entity. There would be significant expenses, in particular legal and surveyors' costs and the landlord's professional fees. It would be a resource-intensive programme, requiring some years to complete.

It might be possible for BT to sub-let the buildings to Openreach, but the sub-leases would have to be consistent with the term of BT's current occupational lease arrangement and could only be granted until 2031. In addition to the lengthy process of preparing plans of the sub-let areas for shared properties, the issue of physical separation and working out the allocation of the various costs applicable to the properties would lead to practical complications involving substantial fees and significant amount time and resource.

Bonds. Some of BT's bonds contain a disposal event of default which is triggered if BT "ceases to carry on its business or a substantial part thereof." A transfer of assets to a new legal entity would trigger these provisions if the assets transferred were within the region of 10% or above. Furthermore, any liability management programme involving seeking bondholder consent will have a cost of at least 10% of face value to incentivise them to tender their bonds; this is not a cost that BT currently views as economic and, if triggered by a structural separation, the cost would likely be passed on to consumers or reduce available funds for investment.

Uncertainty over Openreach boundary. Whilst Professor Helm claims that "the [relevant] assets and staff are clearly identifiable" this is not actually the case and the exact boundaries with regard to assets between the two businesses will not be clear. For example, is duct (or the fibre within it) which runs between two local exchanges part of the bottleneck access network or is it the core network? Further, having regard to the fact that a high proportion of the UK already benefits from two competing access networks, there must be a high probability that if other CPs also invest and roll-out their own access networks, as Ofcom anticipates, those geographic markets will become competitively supplied. But it is by no means clear how, with the passage of time, network assets that had belonged to the structurally separated 'utility' access company could be transferred out of that entity and back into BT plc as those markets become competitive. Nor is it clear how areas which are already considered to be competitive for some Openreach services, but not for others, should be treated.

BT certainly does know where its assets are, what is less clear is where is the boundary between the "utility" part of the group and the competitive part, especially as, for example, sometimes a duct may be a conduit for both a regulated and a non-regulated service. As explained above, many buildings also provide accommodation for both regulated and a non-regulated services.

Customer and supply contracts. Hundreds of contracts would need to be reviewed to understand the extent to which such contracts could be novated/assigned and obtaining consents would be time-consuming and potentially costly.

Intellectual Property Rights. IPRs owned by BT would need to be licensed/transferred to the legally separate entity. Consent to transfer/sub-license any third party intellectual property may be needed.

Shareholder consent. BT's shareholders will need to consent to any transfer of assets to a non-BT owned legal entity if the transfer is classified as a class 1 transaction under the UKLA Listing Rules. It is by no means certain that shareholders would consent if they felt that separation caused 'value leakage'.

In summary, the complexity, costs, timescales and disruption would be enormous and obviously disproportionate.

3. Reflections on Ofcom's initial conclusions to the DCR

Ofcom has explained why breaking up BT would not in itself lead to better service or more investment[3]; and that structural separation would only be considered if a strengthened model of functional separation did not address their concerns. [4]

The UK is ahead of its European peers when it comes to superfast broadband and we want it to maintain that position. That is why BT is keen to make significant additional investments over the next five years and beyond. Such investments to build an even faster network would be open to all our competitors to use, on exactly the same terms as for the current generation of fibre.

We also plan to address slow speeds in the final five per cent of the country.

We think we can increase the speeds on our broadband networks so that over 99% of UK premises can receive a minimum 10Mbps, when other networks, like cable, are taken into account, and we can deliver this by 2020 once we get the green light from Ofcom with regard to the outstanding regulatory matters.

Specifically we need three things:

- first, we need Ofcom not to price regulate Openreach's fibre broadband product, so that we can find the best commercial way to pay for this investment
- second, we need Ofcom's support to allow us to deliver the technology solutions that will make this commitment cost effective, particularly for our long reach VDSL technology

[3] 6.59 *Making communications work for everyone*, Ofcom, February 2016
[4] 6.74 *Making communications work for everyone*, Ofcom, February 2016

- third, we need government support in the form of policy commitment and flexibility in BDUK contract.

It is also important that we give small businesses further options aside from dedicated lines, which suit many but not all.

Customer expectations have increased dramatically in recent years and we are keen to work with Ofcom and industry to meet those expectations. We all want to improve service. Openreach is already subject to regulated service standards and we are happy to work with Ofcom to improve them.

Regarding our ducts and poles, these have been available to our competitors since 2009 but there has been little very interest in investing to date. We will see if that now changes, and what changes we can make if there are shown to be genuine obstacles for competitors that are in our control to remedy, something Ofcom will be consulting on. However, fibre investment involves long term paybacks, and improved access to our ducts and poles won't change this materially.

Our plans would help ensure the UK remains the leading digital nation in the G20 and we are keen to get on with the job. They involve large scale investment and that requires a high degree of regulatory clarity and certainty, something that is missing at present. This gives us added impetus to resolve outstanding issues. A voluntary, binding settlement is in everyone's interests and we will work hard to ensure one is reached.

BT Group

11 March 2016