

## Failsafe Mechanism and the Independent Verifier

### Introduction

1. This document is submitted on behalf of INCA and Zzoomm in advance of Ofcom publishing its consultation on the potential competition effects of Openreach's proposed Equinox 2 (**E2**) discount scheme.
2. It is our hope that Ofcom will take into consideration our concerns as set out below when developing its proposed conclusion of whether E2 is likely to cause harm to competition and ultimately consumers.

### Background

3. On 1 July 2021 BT notified Ofcom of a FTTP pricing offer, Equinox 1 (**E1**). On 30 September 2021, Ofcom published a statement setting out its assessment of E1 and Ofcom's conclusion that it should take no action in respect of E1 (**E1 Statement**).
4. Whilst industry members (including INCA) argued that E1 would distort ISPs behaviour by encouraging ISPs to buy from BT in preference to altnets, thereby acting as a barrier and/or deterrence to competitive market entry and expansion by altnets, Ofcom rejected those arguments.
5. E1 did not contain any behavioural commitments to protect against the market distortions alleged by industry and did not contain any mechanism analogous to the failsafe mechanism (**FM**) proposed by BT and described further below.
6. On 14 December 2022 BT notified Ofcom and industry of a further FTTP pricing offer, E2. E2 is yet to be assessed by Ofcom.
7. A new element of E2 (not found in E1) is the FM, described in:
  - 7.1. pdf slides published by BT on 14 December "Equinox failsafe Mechanism – Overview" (**FM Slides**); and
  - 7.2. contractually defined in Section 9, Appendix 1 and Appendix 4 of the "Equinox FTTP Offer Contract – Supplemental Agreement" (**FM Contract**).

## Overview of FM

8. The FM mechanism is not simple. Whilst the FM Slides and FM Contract need to be referred to for detail, key details of the FM include:

8.1. the process is **not automatic**: each quarter an ISP must assess whether it has met thresholds, then (subject to various things) the ISP may apply for a recalculation of its performance for such quarter using the FM (FM Contract Appendix 1, 9.1);

8.2. the process is **administratively onerous and resource intensive**:

8.2.1. separate notices must be provided to BT each quarter (FM Contract Appendix 1, 9.1 and 9.7);

8.2.2. in addition a 'Relief Application Notice' is to be submitted to the Independent Verifier each quarter **(IV)** (FM Contract Appendix 4, 1);

8.2.3. further the ISP must submit, in a format and at a level of detail to be determined, each quarter (FM Contract Appendix 4, 2):

*(a) full and accurate details of all of those Premises where the Communications Provider could at the start of that Contract Quarter sell Eligible Services including for each Premises the UPRN ("the Relevant Premises");*

*(b) reasonable evidence that the Communications Provider is able to order Eligible Services at each of the Relevant Premises;*

*(c) reasonable evidence that the Communications Provider has IT systems and sufficient infrastructure (including proof of interconnection and handover points with the Alternative Network Provider) in place to order and consume Eligible Services at the Relevant Premises and in the Contract Quarter; and*

*(d) such other information as the Independent Verifier may reasonably require from time to time to ensure the accuracy and veracity of the data.*

8.3. in addition to the information listed in 6.2 above being administratively burdensome, the **information provided is highly commercially sensitive** and will provide BT with **detailed market information about the roll-out of each of its competitors** with no controls over the use of such information by BT;

- 8.4. the process starts from the assumption that the failsafe mechanism does not apply unless the ISP proves that it should, thereby placing a **heavy evidential burden on the ISP** to prove that the FM should be applied (FM Contract, Appendix 4: 2, 3 and 8)
- 8.5. the process is **retrospective**: it happens after each quarter and no change to the ISPs eligibility for discounts (and obligation to pay bills) arises until the end of the process. Unlike interconnection agreement adjustments, no interest is payable and this creates a negative impact on ISPs' working capital and real value received even if they are successful (FM Contract Appendix 1, 9.3-9.7);
- 8.6. the **independent verifier is appointed by and paid for by BT with no transparency over its terms of appointment or reference** (FM Contract Appendix 1, 9.2, 9.8), although the costs (over which the ISP has no control) may be charged to the ISP in some (vaguely defined) circumstances (FM Contract Appendix 1, 9.2, 9.8);
- 8.7. irrespective of network availability and/or the impact on altnet orders, **if a threshold for legacy service orders is reached, the FM does not apply** (FM Contract Appendix 1, 9.10). This means that the failsafe mechanism is disapplied in precisely the circumstances when it is most needed. Consider the situation in which an altnet provides a service preferred by an ISP in an area and so, (absent E2) would secure orders for all the premises capable of receiving FTTP in such area. This scenario would almost certainly **triggering the 'all bets are off' contractual get out for BT**;

## Questions to be asked about FM

9. In considering FM as part of E2, we suggest that Ofcom needs to consider (at least) three questions:
  - 9.1. First, what is the **competitive harm** that the FM seeks to address?
  - 9.2. Second, is the FM **in principle capable of addressing the competitive harm** identified?
  - 9.3. Third, does the FM as proposed **in practice address the competitive harm** identified?

We set out INCA's views on each of these three questions below.

What competitive harm does the FM seek to address?

10. It appears that the FM has been designed by BT to remove overbuild areas from the Fibre Only (FO) performance measure. Despite denials from BT, many altnets considered that the FO performance measure in E1 could distort ISPs' behaviour. The FO performance measure in E1 would make it unattractive for ISPs to ever buy from one of the alternative providers of FTTP for fear of losing the available discounts. Thus, E1 was considered by many altnets to create a barrier to entry for altnets as it would be very difficult for ISPs to justify buying from altnets.
11. BT continues to reject the concerns expressed in responses to the E1 consultation concerning the FO performance. The fact that Ofcom allowed the FO measure through suggests that they did not believe it would distort CPs purchasing behaviour. It is interesting, therefore, that the FM has now been introduced and appears to be tacit acceptance by Openreach that the FO performance measure did create the market distortions altnets warned about.
12. As set out in our inputs to Ofcom's evaluation of E1, INCA continues to believe that the Equinox pricing offers (both E1 and E2) are BT leveraging its ubiquitous network and size of installed base to distort competition in the market for FTTP by incentivising ISPs to place orders with BT in preference to the smaller altnets. It appears that this is the competitive harm that FM seeks to address.

#### Can the FM in principle address the identified competitive harm?

13. A properly designed and implemented mechanism to remove overbuild areas from E2 could, in theory address some of our concerns with E2. However, for the reasons set out below, the FM (as proposed) has both design and implementation flaws that means that it fails to address the harm it purports to mitigate.

#### Does the proposed FM in practice address the identified competitive harm?

14. Whilst a properly designed and implemented mechanism to remove overbuild areas from the scope of E2 would be welcome in principle as a way to address the market distortion caused by E1 discount structure, INCA's view is that the FM as proposed by BT has design flaws, is lacking in detail, places a severe administrative burden on ISPs (as noted in paragraph 8.2.3 above), and cannot be regarded as fit for purpose. To be made fit for

purpose, considerable additional information will be needed about how it will operate and we cannot believe the FM can be made operational by April 1<sup>st</sup>. Without the FM, E2 is only a means by which BT can offer lower prices in the market about which we have concerns explained elsewhere.

15. We believe that the FM cannot be operational by 1<sup>st</sup> April for the following reasons.
16. First, from a design perspective the FM proposed by BT has (at least) the following fundamental flaws:
  - 16.1. Openreach's ability to intervene and disapply the FM if ISPs take more copper lines in overbuild areas (which can be expected to happen as a direct result of buying from altnets) removes its impact in circumstances in which it may be most required;
  - 16.2. there may be circumstances where the FM doesn't help, in particular where customers are proportionately more likely to take copper in non-overbuild areas. This could happen if altnets target areas where customers are proportionately more likely to take-up FTTP; and
  - 16.3. it requires the sharing of commercially sensitive near real-time roll-out plans of new market entrants with the only market participant with significant market power (i.e., dominance). Ofcom should have competition concerns over the sharing of this type of market sensitive information between *any* market participants, but for it to be required by a dominant operator as part of a proposal purported proposed to address competition concerns is deeply troubling.
17. Second, the process is onerous and resource intensive and therefore costly to operate for ISPs who will have to provide detailed information to the IV on where they can and do use altnets. We do not think that ISPs will invest in hiring people and putting in place systems to effectively use the FM when they can just buy from BT to secure discounts without additional cost instead.
18. Third, the process is retrospective and will not place ISPs (even if successful) in the same position they would have been if they had only ordered from BT.
19. Fourth, the Independent Verifier (IV) is a key component of the FM. The IV is defined in the E2 Contract as an "*independent third party entity appointed by Openreach to conduct the*

*Verification Process*” details of which are only provided to ISPs on request.<sup>1</sup> Aside from circumstances in which the ISP does not comply with the process, BT will fund the IV.

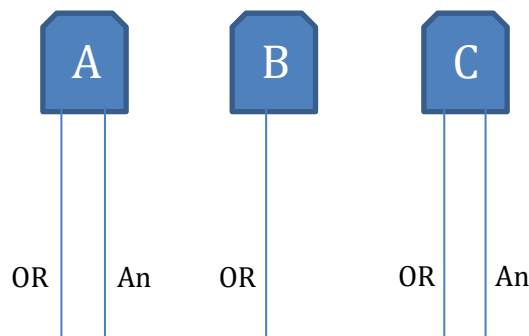
20. The fact that the IV is appointed and funded by BT with no transparency over its terms of appointment or reference and its identity is only made available to CPs on request raises concerns about the true independence of this function. At worst, the IV could be a route for BT to acquire highly detailed information about the extent of competing networks that is not available to altnets. This would provide BT with advance notice of the medium term threat to Openreach. BT would only get this information due its position of Significant Market Power (SMP) and its discount structure. Indeed, an argument could be made that the FM is specifically designed to obtain such competitive intelligence and thus, far from addressing the market distorting effects of the FO performance measure, actually increases them.
21. Thus, it is our view that before E2 can be allowed to be launched by BT, the independence of the IV and the confidentiality of information, must be addressed to the satisfaction of all stakeholders, including altnets.
22. Fifth, The IV will require significant data input from altnets to be able to establish whether a CP can buy connectivity from Openreach only or from one or more altnets as well. The number of households that can connect to FTTP is growing rapidly. According to Ofcom, 4.3 million more homes had access to FTTP by the end of 2022 than one year earlier<sup>2</sup>. That equates to 11,780 households per day. Whilst Openreach will account for a large share of this number, even if for only 50% of new connections, that would still be around 6,000 new connections per day.
23. For the IV to be able to determine whether any property is in an Overbuild Area, the IV will need to have substantial database capability and will need a process in place to verify the data it is provided with. Most importantly, the IV will need to get the support of all altnets to agree to provide data for which they are likely to need to be satisfied that the IV will treat the data confidentially.

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<sup>1</sup> Openreach “Equinox FTTP Offer Contract – Supplemental Agreement” Page 5 and Para 9.2

<sup>2</sup> Ofcom (2022) ‘*Connected Nations 2022*’ December 2022, page 8.

24. This is clearly not the job for an individual but will need a significant organisation.
25. We question whether the requisite organisation can be developed in the three months available to Openreach before it launches Equinox 2. Without a proper IV organisation in place, it is our view that Equinox 2 should not be launched.
26. Sixth, Openreach defines an “Overbuild Area” as one where an ISP can place an order for FTTH with an alternative supplier, and the extent of this Overbuild Area is determined by the IV<sup>3</sup>. We consider that this definition is far too vague to be considered fit for purpose and that Ofcom should require BT to provide a more detailed definition that is acceptable to all parties.
27. Taking BT’s definition at the most micro level, an Overbuild Area could be defined on an individual premises basis. Suppose there are three adjacent properties in the same street and that two of these properties have connections via both Openreach and an altnet, but one only has a connection via Openreach, as per the illustration below.



28. Property B could be defined as outside the Overbuild Area because it does not comply with the definition in the E2 contract as a CP cannot place an order with an altnet at this property.
29. On a more macro basis, an Overbuild Area could be a whole town or city in which some premises are connected to fibre from Openreach and others and some are not. If the three properties in the illustration were districts in the same city, then under the macro

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<sup>3</sup> Op cit footnote Page 6



definition, district B could be included in the Overbuild Area, even though a CP can only use BT in this part of the city.

30. Absolute clarity and transparency of the definition of a the overbuild area must be built into the E2 contract before it can be considered fit for purpose.
31. Seventh, we note on Slide 2 on the FM presentation that “Openreach reserves their right to review and amend the Failsafe Mechanism if its use results in CPs placing a disproportionate level of orders on Openreach copper in the Overbuild Area”. A similar statement is made on Slide 4.
32. The definition of “disproportionate” is important to the implementation of the FM. Paragraph 9.10 of the Openreach Contract appears to define it as “50% greater than the Benchmark Legacy Number”. Whilst this provides some clarity, the calculation of the benchmark appears to be at the discretion of the IV, which is appointed by Openreach. The more cautious the CP about the future behaviour of BT, the more they are likely to order fibre from Openreach to protect themselves against future amendments to the FM that could harm their interests.
33. The definition of an Overbuild Area is important for determining whether the level of orders on Openreach copper is “disproportionate”. The more macro the definition, the more it resembles the Offer Area as defined in the E1 contract. This would mean that in Overbuild Areas CPs would still be incentivised to purchase FTTP lines from Openreach to avoid BT deciding that the proportion of copper lines the CP bought was disproportionate.

## Conclusion

34. We do not believe that the FM and the IV process can be redesigned to be fit for purpose, then implemented to the satisfaction of all parties, including investors in alternative networks, before the planned implementation date of Equinox 2 in April 2023. We believe, therefore, that Ofcom should not allow Equinox 2 to be launched until these critical processes are agreed by the industry as fit for purpose.