

ANTICIPATED ACQUISITION BY BT GROUP PLC OF EE LIMITED

Summary of hearing with CityFibre on 12 August 2015

Overview of CityFibre

1. CityFibre told us that it had been founded in 2011 through the acquisition of a small number of fibre companies that had fibre infrastructure in a number of towns and cities (around 50). It entered the market specifically to build modern fibre optic infrastructure in mid-tier urban areas; not central London or rural areas. Its geographic focus was on towns and cities outside of London with a population of 50,000 or greater. In total there were about 130 target towns or cities that met that brief and its target roll out plan was to reach about 100 of those towns and cities over a seven to ten year period.
2. CityFibre saw this as a market where BT had infrastructure dominance, where there was opportunity for innovation and competition and that the market could be better served through an alternative supplier of infrastructure.
3. CityFibre now had infrastructure presence in 61 towns and cities, ranging from around 10 kilometres of fibre infrastructure, up to the top end in excess of 100 kilometres.
4. CityFibre's current strategy was to drive for what it called Gigabit City projects, which meant delivering extensive fibre infrastructure into the local access market of those cities, in excess of 100 kilometres of infrastructure.
5. CityFibre had to date got Gigabit City projects underway in York, Coventry, Aberdeen, Edinburgh, Hull, and Huddersfield. Two particular projects were [redacted].
6. CityFibre explained that its model for infrastructure build and financing was an anchor tenancy model, which was a standard feature in infrastructure builds. Many of its city projects were at the first stage, the anchor tenancy stage in building of the core network. The project in York was the one that was most advanced, and this was now moving into its fibre to the home stage.

Funding

7. CityFibre was a vehicle for roll out of fibre infrastructure supported by a range of institutional investors that provided both debt and equity capital. To date

funding had been through large institutional shareholders, of which Aviva and British Steel Pension Fund were examples. Its current debt provider was Citibank, and CityFibre was currently in the process of looking at a broader range of banking relationships for the provision of debt.

8. CityFibre told us that it was pre-approved for a £500 million loan guarantee from Infrastructure UK, which it could draw down on a defined project basis. It explained that the purpose of the UK Guarantee scheme for infrastructure was to encourage third party commercial lending to infrastructure projects. Infrastructure projects of this nature would have a long-term payback: seven to ten years or longer. So it would provide an element of comfort to lenders if the government was standing behind it.
9. CityFibre had been pre-approved for the UK Guarantee scheme due to the importance of fibre infrastructure roll out to the government's infrastructure plans. The pre-approved facilities were to support CityFibre's roll out to its target 100 cities.
10. CityFibre did not need to raise all of that capital in one go. It would raise capital dependent upon the deployment or capital that it needed in any given period of infrastructure deployment, typically on a rolling 12-month basis.
11. There was an ongoing requirement that guarantees are linked to commercial contracts. They would not enable CityFibre to fund the speculative build of infrastructure; they needed to be contract-backed deployments. Therefore, there was a dependency on a form of anchor tenancy, but the pre-approval was not specific to any particular form of anchor tenancy, although the facility was best used to support a multi-city roll out to accelerate the pace of infrastructure roll out.

Overview of CityFibre's concerns

12. CityFibre's concern was that post-merger, BT would want to self-supply backhaul, and this would limit the potential for CityFibre (or other suppliers) to contract with EE or MBNL (the joint venture between EE and Three). This would reduce and/or delay the roll out of independent fibre networks, which would have a follow on impact into the viability of roll out of the fibre to the home networks.
13. CityFibre also had a general concern that BT would now be entering into competition with mobile network operators (MNOs), which could lead to service quality degradation, and pricing or margin squeeze concerns BT Wholesale was currently supplying the majority of fibre mobile backhaul connections that were subject to contracts for unregulated products.

Anchor tenancy

14. CityFibre told us that the opportunity to contract with MNOs for the provision of backhaul would be as an anchor tenancy that spanned multiple cities. Whereas, for example, a local authority contract would be done very specifically just for one city unit.
15. By anchoring with the public sector, CityFibre would be subject to public sector procurement rules, which took quite a lengthy time to complete and were usually for individual cities only. Its current run rate of adding new cities by anchoring through the public sector was around one per quarter, so about four contracts a year.
16. The opportunity for MNOs to anchor CityFibre in multiple cities was supportive of its financing plan for a larger scale roll out into its target 100 towns and cities, potentially utilising the £500 million loan guarantee from the government's Infrastructure UK.

Mobile backhaul

17. CityFibre disagreed with BT's submission to the CMA on market definition. It said that mobile backhaul and general leased lines operated very differently. For example, the length of contracts for mobile backhaul were very different than for business customers. Business customers typically contracted on a short-term one to three year contracts. Mobile operators sought more stability in longer term contracts, and would also look to shift more towards a high-capex low-opex model.
18. MNOs today bought predominantly managed bandwidth services from BT Wholesale, and a small amount of supply from Virgin Media. But that managed service contract provided all the optical components that sat across the dark fibre. So as mobile operators were shifting towards dark fibre, they would change the operating model, and would have to take more control over the active electronics. The process of doing that wasn't necessarily complex but it was a new model that they would need to adopt.
19. Cityfibre said that there was plenty of expertise within the mobile community to manage the dark fibre and put the optics on the end and run those services, and plenty of organisations around that would do this (eg Ericsson and Nokia).
20. Based on CityFibre's discussions with MNOs there was a clear and strategic intent for them to decouple the infrastructure cost from the bandwidth. A benefit of dark fibre was that they could increase the bandwidth across that

fibre connection independent of the cost of the fibre itself. As data usage in mobile accelerated, this gave more control over the cost dynamics of their infrastructure as opposed to continuing to buy ever increasing higher bandwidth supplied services which always came at a cost premium from BT.

21. CityFibre had spoken to a number of different operators across Europe and beyond, some with multiple operations in different countries, and they very much talked about this being their preference, but it was largely governed by the availability of dark fibre. This was a common move in other countries and typically the supply was a competitive supplier of dark fibre, not necessarily from the incumbent.
22. In the UK, CityFibre expected that probably around about 50 to 60% of cell sites would move to a dark fibre solution and the remaining sites would continue to be supported via microwave technology.

Ofcom's proposed regulation

23. Cityfibre explained that Ofcom was proposing to regulate the supply of BT dark fibre, and CityFibre was concerned about the proposed pricing. In its submissions to Ofcom it had said that Ofcom's proposed pricing was incorrect, because it was based on the economy of scale of BT's infrastructure and not on the broader economy of scale of a reasonably efficient operator, which was the accepted model where infrastructure competition was being deployed, either currently or prospectively. CityFibre's analysis showed that the proposed regulated price would be up to 80% less in the regulated market than in London, which Ofcom had considered to be a competitive market. This would effectively lead to a foreclosure of the competitive infrastructure market.
24. Cityfibre said that if the dark fibre proposal was implemented as Ofcom currently proposed, then that would be harmful for all infrastructure providers in the market, not just for CityFibre, but anyone who was providing competitive infrastructure (whether in London or outside) could be potentially driven out of the market.
25. CityFibre was not opposed to regulated access to BT dark fibre in principle; at the right price, then it would be a healthy dynamic in a competitive market and something that would not be a major inhibitor to CityFibre's roll out plans. It could even accelerate CityFibre's plans in that there would be a bigger dark fibre market, with communications providers moving towards purchasing their own electronics at an accelerated rate.

26. CityFibre was a member of the Infrastructure Investors Group (IIG) (whose members also included Virgin Media, Zayo Group and EU Networks), which shared its concerns.
27. Ofcom's proposals had also introduced quite a significant factor of fear, uncertainty and doubt into the industry over whether BT's dark fibre would become available and whether it would be set at the price point that Ofcom had indicated in its consultation documents. CityFibre was seeing this across a number of projects and opportunities. It had affected buying decisions and procurement decisions in the market.

Competition

28. CityFibre said that where infrastructure competition had emerged in London, BT's market share in the supply of connectivity in London had fallen to around 35 to 40%. Whereas outside London its share was in the 60 to 70% range.
29. CityFibre said that the regional towns and cities of the UK could support three to four competing infrastructure providers. The key factor was having sufficient density to support the CAPEX of rolling out somewhat duplicative networks – however, CityFibre also said that its new modern pure fibre networks would bring substantial benefits over BT and Virgin's networks which still utilised a high proportion of copper or co-axial cable connections.
30. CityFibre disagreed with BT's and Ofcom's view that there was no separate mobile backhaul market. It saw mobile backhaul as a separate market with very specific characteristics, both technically and commercially.
31. CityFibre disagreed with BT's and Ofcom's view that, in infrastructure terms, the UK was a single national market, as the dynamics for competition, investment and utilisation were different in rural areas, due to lower density, and different to central London which had higher density.

CityFibre's discussions with MBNL and Three

32. CityFibre said that MBNL was a 50/50 joint venture between EE and Three, and it had been put in place to make significant savings on operating costs. By sharing cell sites, the two major areas of savings are site costs (rent and power and rates etc) and transmission costs.
33. CityFibre had signed a framework agreement, which was a four party agreement with MBNL, Three, EE and CityFibre; [REDACTED].
34. [REDACTED]

35. CityFibre believed it was clear that BT would look to self-supply to EE. This would create a material reduction (potentially up to 100%)¹ in the volume of sites within the MBNL agreement because the backhaul connectivity under the MBNL network sharing arrangement would be provided by BT. Whilst Three could in theory procure unilaterally for separate backhaul, the commercial viability would be impacted as the benefits of the network share arrangement would be negated.
36. BT self-supplying mobile backhaul to EE would slow down the roll out of CityFibre's network and this would be likely to result in a smaller quantity overall as well.

CityFibre's discussions with EE

37. [REDACTED]

Other potential customers

38. CityFibre said that [REDACTED].
39. CityFibre said that [REDACTED].
40. [REDACTED]
41. CityFibre said that [REDACTED] its business model worked with a view of a certain penetration to those other competitive markets, so public sector, business and MNO backhaul in conjunction with the roll out.
42. CityFibre said that public sector contracts were typically under relatively lengthy term contracts: five to seven years was very common. So there was a timing aspect of contracts coming up for renewal in their procurement cycle. That had an immediate effect in limiting the supply. They were also subject to quite intensive procurement processes, typically anything from a six-month to a 12-month procurement cycle. That was leading to a run rate of one city per quarter. If CityFibre were to use that model, its timing to get to its ambition of 100 cities would be a two decade roll out rather than a five year roll out.
43. In the business market, CityFibre had anchored two projects in Aberdeen and Edinburgh with business internet service providers, but there were very few of those types of service provider opportunities. In most of the targeted towns and cities one would not have found a single service provider that worked as

¹ In the hearing, CityFibre stated that this would affect 50% of sites, but subsequently clarified this statement as referring to 100% of sites.

a natural anchor tenant. The projects in Scotland were specific and local to the Scottish market. There might be one or two more cities that follow on that basis but there weren't going to be any scaling opportunities in that sense with the kind of business ISPs.

Small cells

44. CityFibre thought providing backhaul to communications providers' small cells was in principle a real opportunity. However, MNOs had been talking about deploying small cells for about five years now, and CityFibre still hadn't seen any significant deployments to date. It was working with a small cell provider right now, but MNO engagement on small cells was still very difficult: they still had to understand where they used them, how to use them, what the model was, how much they cost, if they had the right solution, what the backhaul solution was, and whether or not they shared them.

Counterfactual

45. CityFibre said that in the counterfactual case, where BT did not acquire EE, MBNL and EE would proceed to procure mobile backhaul from CityFibre in a large number of towns and cities. [REDACTED]. BT did not currently offer dark fibre mobile backhaul services, and in the towns and cities that were being discussed with CityFibre (whether for joint or unilateral procurement) there were few alternatives to CityFibre. The strategic intent to move to dark fibre connectivity where feasible was clear and supported by public statements by both Three and EE.