

Business Connectivity Market Review
Leased Lines Charge Control
Review of BT's cost attribution methodologies

UKCTA Response to Ofcom

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UKCTA is a trade association promoting the interests of competitive fixed-line telecommunications companies competing against BT, as well as each other, in the residential and business markets. Its role is to develop and promote the interests of its members to Ofcom and the Government. Details of membership of UKCTA can be found at www.ukcta.com.

Due to the number of overlapping issues this UKCTA response combines submissions on the Business Connectivity Market Review (BCMR), the Lease Lines Charge Control (LLCC) and Ofcom's Review of BT's cost attribution methodologies. The Document is structured as follows:

1. Business Connectivity Market Review
2. Leased Lines Charge Control
3. Review of BT's cost Attribution Methodologies

This submission does not necessarily represent the views of EE or Virgin Media, reflecting neither agreement nor disagreement with the views expressed.

1. BCMR

QoS

- 1.1 UKCTA fully supports Ofcom's review of the Quality of Service (QoS) provided by Openreach to its customers. This has been a considerable source of contention between BT and industry over a number of years, during which time we have seen continuous degradation of the level of service provided by BT. UKCTA members have been highlighting for many years concerns over the QoS provided by Openreach, particularly, although not exclusively, with regard to the service delivery performance. Despite raising concerns directly with Openreach through industry forums and Ofcom through responses to a number of consultations (e.g. BCMR CfI April'14, FAMR December'13) the situation has not improved. Indeed UKCTA members would argue that it has deteriorated. UKCTA is therefore pleased that Ofcom, initially through the Fixed Access Market Review and now the BCMR, seems to have acknowledged that action is required to address the situation. However, the proposals as they stand do not go far enough nor do they reflect the urgency that is required in terms of the speed of implementation.

Assessment of BT's QoS in providing Ethernet leased lines

- 1.2 UKCTA agrees with Ofcom's overall assessment that BT's QoS in providing wholesale Ethernet leased line services is not acceptable, with significant and persistent deficiencies over the past four years particularly with provisioning performance but also to some extent with repair performance. Accordingly, we strongly agree with Ofcom's intention to impose obligations on BT to drive improvements to its provisioning performance. However, we have concerns that Ofcom is offering unwarranted benefits to BT in terms of incentives to further this improvement. UKCTA members are concerned that under the current proposals, BT stands to benefit unduly for rectifying its past performance failures, failures which have been solely down to BT's internal business decisions. In other words, BT has consistently failed to invest in providing a fit for purpose service to its wholesale customers and may now unfairly gain from making the necessary improvements.
- 1.3 However, UKCTA members do recognise the issue Ofcom is seeking to address in preventing BT having the opportunity to switch resources from repair to provisioning in order to address deficiencies in one area by degrading service in the other. This again was a point that UKCTA members have flagged previously and which certainly requires attention.
- 1.4 Ofcom's proposed Provisioning targets are not sufficiently challenging. Although Ofcom has generally identified the correct issues requiring remedy, the proposed solutions are considered to be insufficiently bold to really drive the improvements industry and end users actually require. This point is typified by Ofcom's proposals in relation to the two sets of minimum standards it has identified; the minimum standard for order completion by agreed date and the minimum standards of provision lead times and repair.
- 1.5 Both of the proposed targets for these two minimum standards fall far short of what is needed. For example, the proposed minimum standard for order completion by agreed date does not achieve adequate performance (90%) until the start of the third year of the BCMR period, whilst the proposals for the minimum standards of provision lead times and repair take until the second year of the BCMR period to achieve a return to 2011 performance levels (with a very minor improvement of less than 1% for percentage of faults fixed within 5 hours). All in all this would be too little, achieved too late. The proposals should be much more ambitious.
- 1.6 Ofcom states that it has taken into account that the new minimum standards will require BT to develop its order handling processes and systems over the next few years and as such has proposed modest initial improvement targets. UKCTA considers such an approach to basically

reward BT for its past poor performance, which is not only unwarranted but fails to take in to account the fact that BT has been aware since 2013, at least, that they would need to take measures to improve their QoS performance. Furthermore, Ofcom itself noted that the deterioration in QoS performance has been caused in part by BT's under resourcing and the failure of its Ethernet Strategic Transformation (EST) programme, two matters completely under the control of BT and for which they should not receive any benefit or time allowance.

- 1.7 UKCTA members are not reassured by Ofcom's view that BT will likely need to out-perform its Year 1 lead time obligations and that as a result the minimum standards set should be seen as an absolute floor rather than an expected performance standard; the fact remains that the minimum standards have been set at too low a level.
- 1.8 It is important that all Business Connectivity services have a quality measure as a minimum safeguard in order to protect other services from being downgraded through BT prioritising EAD to avoid fines in periods where QoS dips. Quality measures should cover OSA and any other new connectivity services subject to SMP obligations.

Enforcement of QoS standards

- 1.9 UKCTA welcomes Ofcom's proposed new QoS SMP condition which will require BT to comply with any QoS requirements Ofcom may direct. Setting aside the fact that UKCTA believes that Ofcom has set the minimum standard targets too low, such a condition is seen as a positive step in addressing the downward trend in QoS performance, particularly with regard to provisioning performance.
- 1.10 However, such a condition will only be beneficial if Ofcom continually monitors BT's performance and acts swiftly and decisively should BT fail to fulfil its obligations; UKCTA sees the rigid enforcement of the ultimately determined QoS standards as absolutely critical in driving improvements in BT's performance in this area. The concept of an enforcement triggered fine is untested; further, without any view on the level of the fine it is not clear how effective such a regime will prove to be. UKCTA would be grateful if Ofcom could share further details on how any fines would be used for enforcement.

SLAs/SLGs

- 1.11 Overall, UKCTA members agree with Ofcom that the current SLGs are totally inadequate and fail to incentivise Openreach even to meet the required standards let alone improve their

performance. We fully support Ofcom's view that the SLA/SLG regime is at risk of being circumvented by the uncontrolled use of deemed consent, something UKCTA members have flagged in response to previous consultations.

- 1.12 Accordingly, UKCTA is at a loss to understand why Ofcom has proposed not to intervene directly in the SLA/SLG regime but instead leave it to industry to negotiate with BT. Given the number of parties involved, each with a different priority, BT will have the incentive and the opportunity to manipulate contract negotiations to aid its own position or at least prevent the reforms required to generally improve the situation. In light of Openreach's continued position as sole supplier for the applicable services, such a policy is tantamount to an abdication of regulatory oversight and will allow BT to manipulate the situation to its own benefit. This is a key area where the regulator needs to intervene, and we strongly urge Ofcom to re-consider its position. Communication Providers, under the auspices of the OTA have now agreed a process agnostic set of requirement for SLA/SLGs, and Ofcom should consider adopting these into the framework under consideration.

PPCs

- 1.13 UKCTA members believe Ofcom should focus on reducing the cost of migration from PPCs to Ethernet services before deregulating further (e.g. especially regarding the proposed deregulation of PPCs above 8Mbit/s) and allowing further price increases of regulated TI services. While UKCTA members agree with Ofcom's view that the TI market is declining, it is still a significant market and our assessment on the actual implementation of migrations and remedies that should be applied accordingly are different from Ofcom's proposal. We explain this in more detail below.
- 1.14 As mentioned by Ofcom in paragraph 5.6 of the present consultation: "the TI market is now in decline and almost all new demand for leased lines services is met by more modern alternatives (e.g. Ethernet and WDM). As a legacy market, we do not expect significant new demand or competition within the TI segment. In this context, the focus of our market assessment is on existing supply and any potential competitive constraints that arise from potential substitution and migration to more modern alternatives." Ofcom appear to give the impression of assuming that migration is happening smoothly and competitively whilst the reality of the situation faced by CPs is very different. The vast majority of demand for TI originates from existing customers that are unable to support the costs of migration. As a result UKCTA members believe TI is still an important market and Ofcom should be careful about the very real possibility of customer harm resulting from further deregulation and price increases, combined with the lack of a suitable process for migration.

- 1.15 A further reason to be careful about the consequences of further deregulation and/or price increases for PPCs is that there are some applications for which PPCs are still required. In particular, they are still used to deliver TDM voice. When those customers need to migrate both their voice and data services, the migration process becomes even more complex. This is due to the following reasons:
- VOIP services are not yet fully substitutable to TDM in terms of quality.
 - When customers currently use TDM voice and have to change their equipment to be compatible with VOIP (i.e. TDM PBX, phones, cabling), the migration cost is even higher. This impacts the customer's decision regardless of the cost of PPC migration itself.
 - Customers are often only willing to consider TDM migration in specific circumstances, often unrelated to cost (office move, desire for extra features).
 - BT has no real incentive to complete the TDM migration. This can be illustrated by the delay in the implementation of the 21CN network. They even declared the following in their response to the 2013 narrowband review: "We also commissioned Bell Labs to study the factors which determine the speed and timing of migration, and produce some case studies. Their conclusion is that whilst migration to next generation broadband voice is seen as an inevitable end state, PSTN shutdown is not expected to happen in most regions until approximately 2020 or beyond."; and "Service providers all have an overlay next generation voice platform, but an industry-wide standard solution for next generation voice does not exist as of yet. Current migration rates to the next generation broadband voice platforms are generally dominated by external (market and government) forces."
- 1.16 If migration requires customers to replace all their voice equipment, their incentives to migrate are weakened. Accordingly, unless the right incentives are implemented on the actual cost of migration, those customers are expected to remain with the legacy product over the next three years. This is a further reason why Ofcom needs to exercise care in order to avoid unnecessary customer harm, resulting from price increases and/or deregulation. Accordingly, before instituting further price increases or de-regulation, UKCTA members believe Ofcom should require BT to develop a migration specific process, with only necessary and efficiently incurred costs allowed, and observe its actual results over the next three years. At the moment, measures implemented by Ofcom to foster the migration (i.e. the LLCC) seem only to benefit BT and harm customers. Once an efficient migration process is in place, UKCTA will be fully supportive of all objectively justifiable proposals on pricing and deregulation.

Migration

- 1.17 UKCTA believes it is important for Ofcom to properly assess any competitive issues faced by CPs in the migration process. The remaining demand for BT's legacy products comes from many customers being stuck on more expensive and/or less functional PPCs or WES, and, this is mostly due to the lack of a fit for purpose migration process implemented by BT.
- 1.18 UKCTA members agree with and understand Ofcom's desire for the market to migrate at the appropriate time to the most efficient technology. However, it is important for Ofcom to be aware that CPs face barriers to migration and these barriers can only be overcome to a limited extent. BT has SMP in all leased lines markets, and WLA markets. This means that BT has SMP in the markets customers are migrating from and the markets they are migrating to. Due to the lack of risk in losing customers (as a result of wide ranging SMP) we consider that BT does not act in a competitive manner and does not adequately assist customers to migrate.
- 1.19 UKCTA has already expressed its views on these issues during the last BCMR consultation and is therefore disappointed that neither BT nor Ofcom have taken steps to improve the situation. We consider that migration needs regulatory oversight on the processes, options and costs.
- 1.20 We describe in detail below the reasons for which we believe it is necessary for Ofcom to address those migration issues directly, and as rapidly as possible. We then explain how this could be enforced by Ofcom. Migrating customers is a complex process that is made even more complex when a third party tail is involved. When migrating a customer from a legacy BT product, all steps needed to complete the migration must be managed by CPs but, at the same time, those steps rely upon factors that CPs cannot directly control. Indeed, on the one hand, the migration requires the customer's agreement and willingness to support all costs associated with the migration, and, on the other hand, it requires BT to offer a direct alternative, which they often do not.
- 1.21 Currently, there is no straightforward migration solution: when migrating a customer, CPs are stuck with a discontinuous cease and re-provide process because they must cease the old connection and order a new one. This cannot be called a migration solution. As such, the customer only receives a true migration service (as opposed to a discontinuous cease and re-provide) when all the costs and complexities are managed by the CP. From a CP's perspective the process is as costly and time consuming as the cease of a leaving customer, plus provisioning for a new customer.
- 1.22 More precisely, the issues faced by UKCTA members for migration are as follows:

- i. The absence of a managed package offered by BT to deal with all types of migrations. This applies to migrations from both legacy technology products and from legacy products but already using Ethernet (i.e. WES to EAD for example). On the one hand, the absence of a migration solution results in important but unfair costs supported by CPs and therefore customers. Indeed, there are many steps in common between the provisioning and cease processes. A proper migration process would integrate these steps. However, at the moment, there are many cost elements that CPs must support that take no account of the fact that a migration is taking place, and not a termination followed by a new order. A “migration” incorporates full new connection charges, ECCs, parallel running costs and early termination costs among others. Also, since CPs are fully in charge of implementing the actual migration process, internal management costs have to be considered and supported by customers. Besides financial aspects, operational ones are also important: without a managed migration process for the BT input, it takes more time to handle the migration internally and ensure the customer’s service is not interrupted. These are all unnecessary costs and complexities, which could easily be avoided if there were a suitable migration specific solution provided by BT. On the other hand, there is often not even an appropriate alternative product available for CPs to migrate their customers. Indeed, UKCTA members face situations where it is not advantageous for customers to migrate, only because there is no suitable alternative product. For example, it is not uncommon to face situations where the closest substitute is for a higher bandwidth and at a higher monthly rental. In such circumstance there is no incentive for a customer to migrate. As a result, we believe more steps and options within the current product set should be offered, to increase the likelihood that there is a tier available for the migrating customer. For example we could have the following: similar SLAs, similar facilities, similar coverage, lower monthly cost, higher speeds, no installation costs, no extra costs (i.e. ECCs, early termination costs of the old service,...).
- ii. The cost of migration is often too high when it requires a change in technology. It is important for Ofcom to recognise that migrating customers from TI to AI services is a very costly process. Moreover, due to the plan to de-regulate the pricing of PPCs above 8Mbit/s and the price increase of PPCs at lower bandwidths, this is becoming a critical issue. Why critical? Because BT is able to migrate to contemporary technology using efficient internal migration processes that are not available to other CPs. BT have a crucial advantage over competing CPs in customer retention, for customers migrating from TI to AI. A new migration process needs to be devised that explicitly considers the needs of customers on legacy technology. Consequently, UKCTA members strongly

believe BT should implement a real migration process that considers all features of both the old and the new circuit and offer to handle any steps involved when needing to cease one service and activate another. Such a solution would result in reducing the overall costs for CPs and their customers.

1.23 For the following reasons, it is not in BT's interest to implement a smooth migration process:

- Once the migration is complete, BT will face more competition from Ethernet services which are provided by an increasing number of suppliers,
- BT has more to lose from facilitating any migration because they earn more recurring revenue from legacy products than they would from the latest product available,
- BT can manage migrations to its advantage. By offering a seamless process that is unavailable to other CPs, it has an inherent advantage in terms of customer experience.

1.24 Therefore, UKCTA members consider that Ofcom needs to act to ensure that an efficient solution is provided. The solution would be a package for migration alongside any latest regulated product currently available. This option would consider all customers' requirements for both their old and new circuits in terms of bandwidth, cost, coverage, contract terms, SLAs, and so on. The absence of any suitable process results in customers remaining on legacy technology longer than necessary, increasing their costs, harming their incentives to switch to new technology, and disadvantaging competitors relative to BT.

2. Leased Lines Charge Control

Labour Efficiency and Starting Adjustments

- 2.1 As Ofcom will be aware from our previous submissions on the subject of BT's labour efficiency, UKCTA believes that BT employs discretionary labour practices that are inconsistent with those normally applied within our Industry and contribute a material additional cost when compared to our assessment an efficient hypothetical CP's cost base.
- 2.2 We maintain the view that BT should quite rightly be free to set its own labour policies in order to support its business requirements, but where BT elects to incur significant expense above Industry norms, then these should demonstrably result in benefits for OCPs and either be agreed collectively with the CPs concerned or, as a minimum safeguard, cleared by Ofcom. Where this is not the case, the incremental costs must be viewed as discretionary and should be borne by BT alone, not passed through in the form of what is seen by many as a stealth surcharge within regulated wholesale pricing.
- 2.3 In UKCTA's opinion, there is a strong and clear case for Ofcom to make a specific, targeted efficiency adjustment in the context of its charge control cost modelling, in order to take account of BT's chosen labour practices so as to remove the unjustified inefficiencies that are clearly apparent.

Efficiency Gains Achieved During Current LLCC

- 2.4 UKCTA is concerned that, during the current charge control period, a significant factor in BT's failure to meet its installation and repair service targets has been as a consequence of excessive reduction of front line staff and related cost-cutting initiatives. The efficiency assumptions made in relation to the 2013 charge controls presumed that adequate staffing levels would be maintained in order to meet the relevant SLAs so all cost savings that BT achieved as a result of excessive staff reduction that went beyond Ofcom's assumptions have resulted in excess profit for BT and this situation will continue through to March 2016.
- 2.5 Worse still, it appears that in order to meet its future SLA obligations, BT will be required to hire and train additional staff in order to rectify the problem. We argue that it is inequitable for BT on

the one hand to have made excessive profits from cutting staffing levels beyond that required by an efficient operator and on the other to be compensated by OCPs through the 2016 LLCC for the additional staff costs necessary to regularise the situation. We propose that the design of future charge controls be such that, where the SMP operator can be shown to have achieved efficiencies that cannot be justified to Ofcom's satisfaction, typically where service levels have been missed, then accounting adjustments be made so as to retrospectively and prospectively amend the affected regulated charges.

Lack of Accounting Transparency Regarding Efficiencies

- 2.6 UKCTA is not confident that OCPs can adequately measure the extent to which BT's efficiency metrics are being met. The wide basket design gives BT considerable scope to elect where it allocates its costs and, when combined with a lack of accounting transparency give insufficient confidence that Ofcom can adequately measure where true efficiency gains have been achieved in the past and will be achieved in future. Moreover, the errors and mis-allocations identified by Cartesian serve to further undermine CPs' confidence that Ofcom can make accurate judgements regarding efficiencies.
- 2.7 The true value of efficiency gains sits within a broad range of possibilities and a high degree of subjectivity must be applied in order to make assumptions for the purpose of controlling charges. In such circumstances, BT has access to financial data that is not available to the regulator and it is entirely possible that whatever decision is taken by Ofcom may be subject to challenge on appeal. In order to increase confidence in the outcome and minimise the risk of challenge, we propose that appropriate action be taken to ensure that the design of future RFS can adequately capture the efficiency data required to give a significantly improved level of certainty.

Target Ethernet Efficiency Within 4% to 7% Range

- 2.8 As noted above, OCPs do not have access to the extent of accounting information available to either BT or Ofcom. The data published in the consultation documentation is heavily redacted, in particular within Annex 8 of the LLCC so our comments are limited to very high level observations.
- 2.9 We share Ofcom's view that the volume of Ethernet connections at 100Mb/s and above is likely to increase significantly during the charge control period but question whether the extent of anticipated 'cannibalisation' due to the launch of a competing dark fibre product will be as high as

Ofcom expects. The rate of take-up of dark fibre will depend on both the suitability of the product itself, the ability of OCPs to consume it and other presently uncertain factors such as the impact of non-domestic property rates on respective business cases, so it is entirely possible that actual Ethernet volumes will be higher than anticipated.

- 2.10 Historically, BT has frequently achieved efficiency savings in excess of those predicted and we note that Ofcom's assessment of BT's gains over the past three years (2011-2014) has been 10.5%. On the basis of the general confidence that volumes will rise, together with BT's potential to develop new synergies during the course of the review period, for instance as a result of their announced M&A activity, we are concerned that Ofcom's proposed 5% assumption, within the suggested 4% to 7% range, falls well short of what will be achieved in practice. Furthermore, BT has indicated that it intends to drive an efficiency campaign directly targeted at Ethernet and other core services and is anticipating considerable staff cost reductions. That BT claims to have already found ways to reduce the cost of supplying products such as Ethernet suggests that this initiative will be implemented during the period of the next charge control. Likewise, the cost benefits of BT's investment in the renewal of a considerable proportion of their vehicle fleet will be delivered during the charge control period and should be anticipated in the context of the LLCC. Likewise, in its 2015 Annual Report, in addition to commentary about overall reduction in operating, depreciation and amortisation costs, BT expresses confidence that there are "plenty of opportunities to reduce costs further" (p23), anticipated £36M power cost reductions (p33, 40), that driving down costs has become a key priority (p59), that their renewed vehicle fleet will reduce operating costs (p63), the use of innovative apps that will improve engineer efficiency (p75) and that they will replace costly and inefficient legacy systems with newer ones (p76). We believe these various actions will cumulatively result in the achievement of cost reductions attributable to business connectivity services in excess of those that Ofcom anticipates.

Balance Between Forms of Efficiency (Allocative, Dynamic etc.)

- 2.11 In general, we agree that it is appropriate to strike a balance between these forms of efficiency and that Ofcom appears to have drawn reasonable conclusions. We would note that, particularly in light of the anticipated volume increases in the Ethernet market, there will be considerable scope for BT to make dynamic improvements in their cost base towards the end of the period and we question whether a straight line approach to efficiency assumptions is the most appropriate.
- 2.12 The data published in Annex 8 suggests that BT has indeed become progressively efficient during the last five years for both Ai (Ethernet) and TI (PPC) baskets and we see no logical reason why this trend should not continue.

Inorganic Factors

2.13 BT's announced acquisition of EE is expected to deliver some £360M annualised synergy savings progressively during the first four years following completion and we anticipate that a proportion of these cost efficiencies will be attributable to the business connectivity sector. If the CMA were to clear this acquisition, then we expect that the combined entity will be motivated to drive through the synergies as soon as is practically possible. We therefore request that Ofcom considers whether any of these predicted savings are relevant in the context of this market review and charge control period.

Promoting Efficiency

2.14 As a general observation, we note that, by its own acknowledgement, BT has not achieved many of the potential efficiencies, despite the effect of successive ex ante measures dating from the first RPI-X charge control many years ago. That there apparently remains such a large gap to close is of considerable disappointment to UKCTA members who rely heavily on BT's products in order to deliver service to their customers. This flows through into higher than necessary charges in the marketplace that must ultimately be met by consumers. Clearly, estimation of future efficiencies is somewhat subjective in nature, but it is of concern that Ofcom's past predictions have tended to be on the low side. Our view is that this next LLCC represents a significant opportunity to reverse the trend of underestimation and ensure the setting of efficiency targets for the business connectivity sector that truly challenge BT to deliver meaningful changes and help make the UK business connectivity market the most dynamic and competitive in the world.

Cost Approach to QoS

2.15 Clearly BT has cut staffing and resourcing level beyond that which was required in order to meet its service level commitments to OCPs. It is clear that BT has enjoyed the benefit from these excessive reductions by virtue of its reduced cost base and that a degree of re-staffing is necessary in order to rectify the QoS deficit. However, we are concerned that Ofcom's proposed inclusion of full resource costs will result in OCPs contributing an unreasonable proportion of the required funding. In our view, OCPs should not be disadvantaged by having to pay for inefficient training costs, overtime etc. when the problem is of BT's making. We therefore propose that such inefficiently incurred costs be removed from the calculation, to be met by BT themselves.

- 2.16 We also propose that the design of the new QoS scheme be such that BT is given a strong incentive to increase the certainty that future QoS targets are achieved and that a clear signal is given that any excessive paring of operational costs to the detriment of quality that will impact service levels towards the end of the control period and beyond will not be tolerated.
- 2.17 The prospect of SLG penalties, where these are set at a sufficiently high level, can be a useful driver of successful delivery. Going forwards, we view all circumstances where SLG payments are made to be examples of inefficient operation on BT's part and propose that such costs be excluded from allocation to the model of allowable costs.

LLCC - Pricing trajectories

- 2.18 UKCTA members fully support Ofcom's intention to impose a series of restrictions on BT's charges, including charge controls, through the control period under review. Such restraints are absolutely a necessity given BT's persistent excessive charging for wholesale access services. We also support Ofcom's proposals to adopt a combination of starting charge adjustments and price caps, the former being necessary due to the leniency of the controls introduced at the last review which has resulted in a significant gap between BT's returns and cost of provision at the start of this charge control period. However, despite Ofcom apparently recognising that they had made errors in the remedies introduced following the last review, Ofcom again seems intent on following a similar approach this time, which has the effect of benefiting BT and disadvantaging its competitors. UKCTA members urge Ofcom to reconsider its current proposals, in particular the adoption of shallow glide paths. If Ofcom considers a glide path approach is the most appropriate remedy then a steeper glide path, aligning charges with costs after 2 years at the most, would be preferable and better serve Ofcom's stated aims.
- 2.19 Having recognised that charges are out of line with costs to such an extent that starting charge adjustments are required, it would be hoped that Ofcom would take appropriate measures this time to ensure such a situation does not reoccur; unfortunately this is not the case under the current set of proposals.

Basket design

- 2.20 Ofcom is proposing to apply charge controls to broad baskets of services; thereby the constraint applies to the weighted average of the charges of the services in the basket. Such an approach allows a great deal of freedom to BT to set charges for individual services within the basket,

which can lead to distortions in competition due to charge reductions being focused on services utilised by its own down stream business.

- 2.21 Ofcom recognises this point and considers that individual service price caps address such concerns. Whilst we agree that price caps have some impact on constraining anti-competitive pricing behaviour, it does not totally address the issue. UKCTA considers that the advantages Ofcom points to for broad baskets primarily favour BT because they have the freedom to choose the optimum set-up depending on the services they use. However, it also has the potential to create distortions between fixed and mobile operators and between fixed operators depending in which markets they operate. Smaller, distinct, baskets allow greater control to be exerted to control such distortions.
- 2.22 Ofcom also states that broad baskets are advantageous to encourage migration to more efficient services, by allowing BT to set higher charges for services supplied using old technology. This was the approach Ofcom adopted at the time of the last review with regard TI services, setting an RPI+ charge control for PPCs. It is evident that Ofcom has radically changed its approach this time around, noting that BT has significantly over-recovered on these services.
- 2.23 Ofcom places a significant reliance on the fact that it has adopted broad baskets following the three previous leased line charge controls, as well as in WBA and ISDN30 charge controls. However, UKCTA would point to the fact that BT has been found to have been pricing excessively in these markets during this time, which perhaps indicates that this approach isn't working.
- 2.24 UKCTA considers that smaller, targeted baskets would still allow a degree of flexibility to address patterns of demand and set relative prices for each service in the basket, whilst addressing concerns regarding the potential for competitive distortions. Overall, UKCTA considers that a broad basket approach will only work if BT is able to cross-subsidise its loss on lower priced services from margins earned on higher priced services. BT's current pricing for 10Mbp/s and 100Mbp/s services indicates that it is not prepared to make a loss on a service. In addition, BT's SMP obligations create a very strong incentive not to price any service in this market below cost.
- 2.25 Despite the concerns highlighted above, UKCTA members do agree with Ofcom's proposal to have a separate basket for Accommodation services, ECCs and TRCs; we also agree with the proposal to once again subject these services to price controls in order to constrain BT's ability to set excessive charges. We also agree with Ofcom's proposals to introduce starting charge adjustments for Ethernet ECCs to bring them into line with charges set for WLR and LLU. Such an approach is fully justified so as to align charges at the start of the charge control period.

However, UKCTA does not agree with Ofcom's proposals in relation to Direct ECCs, where Ofcom plans to allow significant increases above CPI for some ECCs, increases which are not fully explained and do not appear to be justifiable in all cases, e.g. blown fibre tubing in duct which is not an overly resource intensive task. We do not consider that Ofcom has provided sufficient information to justify the charge controls set. As such, we urge Ofcom be more transparent about its methodology in setting the value of X and explain, more fully, how it reached the values set out in its proposal.

Glide paths

- 2.26 UKCTA notes Ofcom's comments concerning the use of glide paths to bring charges in line with efficient costs over time and that this is the preferred approach. UKCTA holds a different view, and whilst glide paths may be appropriate under certain circumstances, in general they unduly favour BT by providing an unnecessarily prolonged period during which prices are significantly in excess of the costs of provision.
- 2.27 Ofcom places a lot of weight on the fact it has adopted a similar approach this time as it has in previous reviews, however given the experience of the last charge control period, it appears the current glide path approach isn't working, as acknowledged by Ofcom by introducing starting charge adjustments. Previous practice is no way to determine future requirements.

Starting charge adjustments

- 2.28 Given the above reservations with Ofcom's approach, UKCTA members fully support Ofcom's proposal to make starting charge adjustments. We agree with Ofcom that, where prices are significantly above cost (as they are for both TI and some Ethernet services) for reasons other than efficiency or volume growth, that such adjustments are appropriate and necessary. However, again, just as for the basket level charge controls, the Ethernet starting charge adjustments are not per charge but a weighted average across all services in the basket. Such an approach provides further significant discretion to BT to game the system to their advantage and is a direct result of Ofcom's preference for broad baskets and to some degree negates the benefits that should result from the introduction of starting charge adjustments. Furthermore, Ofcom's approach to managing changes in cost allocations (and accounting errors) between regulated markets by application of a glide path also plays to BT's advantage. BT has the discretion to change cost allocations from one market to another, taking advantage of the timings of the various market reviews to game the system to its own advantage.

2.29 The application of a glide path, and especially a shallow glide path, simply allows BT to avoid its liabilities for longer. Accordingly, UKCTA members consider that Ofcom's current proposals in regard the balance between starting charge adjustments and charges requires a rethink to address the gap between charges and costs sooner.

The value of CPI-X and the starting charges

2.30 The basic principle behind an inflation-X charge control is that prices should match forecast costs at the end of the charge control period. The purpose is to incentivise the regulated firm to outperform its forecasted costs (and retain the benefit of its performance). As we are aware, BT has consistently outperformed its forecast costs for Ethernet services. Ethernet services remain a very profitable product set for BT – as evidenced by the need for significant starting charge control adjustments.

2.31 However, we do not consider that BT's profitability is linked to the fact that it has performed exceptionally efficiently in relation to Ethernet services. Rather, the more likely explanation is that the cost forecasts from the previous review were incorrectly set. In its current proposals, Ofcom seeks to make volume and efficiency corrections via a glide path. This will:

- i. Continue to reward BT for what (with hindsight) amounts to an error in the previous charge control; and
- ii. Weaken the incentive effect of the charge control, since BT will continue to profit throughout the charge control period without any improvement in its efficiency.

2.32 We do not consider that it is appropriate for consumers to pay higher prices for the next three years to correct an error in Ofcom's cost forecasting. From a design perspective, it is much more efficient to fix that error now and reduce the value of X.

2.33 In summary, whilst UKCTA members consider the general framework Ofcom has set out for designing the proposed charge controls for TI and Ethernet services is reasonable in many ways, there are issues with the application of the framework. In particular, we have strong concerns over the use of broad baskets and glide paths, which require a rethink to ensure the remedies introduced fully meet Ofcom's aims of promoting competition in leased line markets.

3. Regulatory Accounting Attribution & Transparency in LLCC reporting

- 3.1 We support Ofcom's proposals for accounting transparency on BCMR regulated services. It is vital that stakeholders obtain reliable cost information about the products they purchase in large quantities. Ofcom should however require more information on the EAD 1G service, providing more granular information around component reporting in recognition of its proposed status as the active reference product for a passive alternative.
- 3.2 UKCTA has long been an advocate of robust regulatory accounting requirements upon BT. We welcome the effort expended by Ofcom to try and improve the regime for the benefit of all market participants. For too long BT has been afforded too much discretion over what attribution rules apply as well as other material considerations which impact the underlying costs in specific markets and the information contained within this consultation serves to highlight just how much influence BT has had over the published numbers. Far from being an impartial source of data, it is clear that decisions have been taken that benefit BT's business over external CPs.
- 3.3 This work is long overdue and illustrates the massive information asymmetries that exist between BT and stakeholders, including Ofcom around regulatory accounting. It also illustrates the extent to which the regulatory accounting output underpins the entire regulatory regime, with Ofcom unable to accurately set charge controls or resolve disputes without access to fair and transparent accounting information.
- 3.4 We are very concerned about scale of the problems identified, both in terms of the 'errors' and the incidence of inappropriate attribution. It indicates a clear failing by BT against its obligations under the Regulatory Accounting Principles, in particular the obligation for accuracy. BT's performance can hardly be described as 'adequate' and the information included in the RFSs is certainly not 'free from material errors'. While we think the work undertaken by Cartesian is to be commended, we cannot share their view that BT's 'cost attribution system is free from bias'. With proposals put forward by Ofcom to remove an astounding £262M from the regulated cost base in just one financial year and with the costs moving almost exclusively out of regulated markets and with other issues identified and not yet remedied, we think these findings speak for themselves. It is hard not to conclude that BT's customers have been significantly over-charged for regulated

services over a number of years, with the obvious knock-on impact on consumers. The failings that have resulted in this situation need to be addressed urgently and decisively.

- 3.5 What is clear is that when the accounts are no longer regarded as being impartial, they cease to be the valuable reference tool used to underpin regulatory decisions or aid stakeholder transparency that they need to be. The work undertaken by Ofcom so far needs to be considered the start of the project, not the end. It is clear that there is much work to be done and that there are many areas that still need to be looked at in detail.
- 3.6 It is clear that audit assurances provided under the current framework are grossly deficient. The audits provide a stamp of legitimacy to the numbers, but with multiple restatements, material calculation errors and clearly inappropriate attribution taking place at staggering scale any legitimacy has been almost entirely undermined. Ofcom need to ensure that they are satisfied that the accounts are fair and accurate through a repetition of this type of deep dive exercise. This should occur at least on an annual basis until such time as the change control process around attribution changes has been imbedded and confidence has been restored.
- 3.7 In respect of the specific mistakes UKCTA welcomes the recent work undertaken by Ofcom and Cartesian to review the accuracy and fairness of allocations and attributions within the regulatory accounts. The mistakes are material and they demonstrate that tighter control and audit measures are needed in the future. The errors have resulted in consumers being overcharged and regulated prices being set too high for many years. There is no case for them not being remedied immediately. We would also like transparency around just how long they have been included within the accounting numbers as it is clear that most of these issues have been recurring over many years and Ofcom need to ensure stakeholders have a clear view on the historic nature of any over-charging. UKCTA would urge Ofcom to provide industry with clear information as to the duration of the identified errors so that the scale of the over-charging can be determined and specify precisely what measures Ofcom is proposing to address the past failings. One approach would be to increase the level of starting charge reductions in affected markets. As to Ofcom's proposals in terms of addressing the errors, UKCTA does not consider that assurances from BT to correct the failings in the 2014/15 RFS is sufficient. This may go some way to addressing the situation in the future but does nothing to address the detriment suffered by CPs in the past; something Ofcom should take appropriate measures to address. As for Cartesian's statement that it considers BT's cost attribution system to be free from bias, this is hardly supported by the findings. In any event, there is a clear failure by BT to provide accurate regulatory accounts and Ofcom must take appropriate steps to ensure clearly identifiable improvements are made to address the significant failings. Decisive action by Ofcom is required

in order to commence the process of rebuilding industry confidence in the regulatory reporting process.

- 3.8 BT's conduct falls short of what is expected and has resulted in UK communications providers paying more and UK consumers paying more. It also has wide reaching competition concerns, with BT able to deflate its cost base in competitive markets to compete against CPs who have no facility to get their common costs subsidised by other parts of their businesses. The attribution decisions identified should all be remedied without delay. This work can't stop here, Cartesian need to remain involved and review further attribution decision and take into account new information until such time as everyone has confidence in the accounts.
- 3.9 There should be a follow up consultation without delay on the remaining issues and Ofcom need to review the assurance framework around the accounts. Cartesian should be tasked with undertaking another review immediately and the audit should be reformed to ensure that a deep dive approach is adopted that picks up on material mistakes not identified by the current approach.

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