Ofcom

FAMR / LLU Charge Control

Charge control on SFI and TRC

TalkTalk Group comments on BT's submissions

Non-confidential version

March 2014

1 SFI / TRC charge control

1.1 Ofcom is proposing to impose a charge control on SFI and TRC services in order to prevent BT charging excessive prices as is currently the case. BT make a number of comments that seem intended to frustrate this objective and allow BT to charge prices above the competitive level. We comment on BT's main points below.

1.1 Contestability and need for regulation

1.2 BT argues that any service that could feasibly be provided by a third party (for instance, work on in-home customer wiring) is contestable and not 'reasonably necessary' (e.g. §21). BT then goes on to argue that price regulation should not apply to these services and/or a price far higher than FAC should be allowed.

1.3 This ignores the straightforward point that even where a CP could carry out the work themselves (since it is on in-home wiring), CPs sometimes have no genuine commercial choice but to use Openreach engineers. This is because CPs cannot be certain whether the fault can be repaired by their own engineers and therefore must use Openreach to avoid a double truck roll (i.e. a visit by CP's own engineer which finds that the fault can only be repaired by Openreach) and the added cost and inconvenience this causes. It is obviously strongly in CPs' interests to avoid using Openreach to repair faults in the home since Openreach engineers are so expensive (✂). That CPs use Openreach engineers for in-home wiring work is because they have no genuine commercial alternative. Openreach has in its submission failed to address this critical consideration at all.

1.4 Openreach make a related point arguing that all SFIs are 'value added' services (§62) – though they do not explain what this means or implies. In any event, whether a service is value added or not is not relevant to whether it is genuinely contestable.

1.5 We consider that it would be useful for Ofcom to explain clearly how it is interpreting 'reasonably necessary', not least since in the case of a new product whether price regulation should apply will depend on whether the product is 'reasonably necessary'.

1.2 Impact of regulating prices

1.6 BT argue that regulating prices (at FAC) will have a negative implications on Openreach's innovation, quality of service and CPs incentives to improve their own diagnostics. These are all flawed arguments.

1.7 With regard to innovation, Openreach argues that they will have no/insufficient incentive to innovate if prices are regulated at FAC (e.g. §10, §32, §56) and so a price above FAC should be applied and/or new services should not be price regulated[1]. Openreach are effectively holding customers to ransom – they are stating that unless they receive supra-normal profits then they will not innovate. Openreach is wrong on many levels:

- Given that incremental costs are less than FAC and invested capital is low the marginal return on capital from investment is probably over 25%[2]. BT's suggestions that it makes 'no margin' or Ofcom's proposals will remove 'all margin' are plainly misplaced.
- Whilst price regulation at FAC might result in *less* innovation /investment than if prices are set at excessive price levels, pricing at FAC will provide *sufficient* incentives for *efficient* innovation / investment. Currently with prices so far above incremental costs there is a risk of inefficient over-investment
- If Openreach needs additional incentive for innovation (since for instance monopolists like Openreach may shirk innovation in order to 'enjoy a quiet life'[3]) then the correct response is firm obligations to provide services upon reasonable request. The solution to underinvestment cannot be to permit supra-normal profits

1.8 With regard to the pricing of new products it is essential that these products (whether variants, developments, or innovations) are also price regulated provided that they are 'reasonably necessary' in the sense that CPs have little commercial option but to use them. Ofcom should in its statement provide an indication/guidance on how any new products should be priced. Further, if new products are exempt from price regulation BT is likely to game this by modifying the products simply to sidestep regulation.

1.9 Openreach argue (§36, §59) that they have made 'significant developments' to the SFI/TRC product set and they list out 7 changes over the last 5+ years (2009 to 2014). On inspection these are trivial and minor changes (with most of them being merely price structure changes). There is very little change in working practices, tools, KCIs, diagnostics, appointing approaches that genuinely improve the service customers receive. We maintain our view that there has been limited innovation (even though prices have been very high).

1.10 Regarding <u>quality</u>, Openreach claims that setting prices at FAC will lead to SFI/TRCs being de-prioritised and engineers leaving jobs unfinished (§52, §73). Openreach is effectively saying – "*if you don't allow us to supra-normal profit we will degrade your*

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[1] Openreach's option 1 proposes a price above FAC and option 2 proposes exempting new services from price regulation

[2] Assume for illustrative purposes that the FAC is £100. LRIC/incremental costs (current and capital) are about 90% i.e. £90. If we assume that within the incremental costs the allowed ROCE on incremental investment (at 8.8%) is £5 and the incremental opex / depreciation is £85 (= £90 - £5). If prices are set at FAC (£100) then the actual ROCE (on the incremental investment) will be £15 (£100 - £85) and the so actual ROCE on incremental costs 25% (= 8.8% x £15 / £5)

[3] The noted English economist John Hicks famously said that "*the best of all monopoly profits is a quiet life*". John. R. Hicks, "Annual Survey of Economic Theory: The Theory of Monopoly," 3 Econometrica 1, 8 (1935).

service". Such an approach would amount to an abuse of a dominant position (and is the attitude of an arrogant monopolist).

1.11 In any case, because incremental costs are lower than FAC Openreach will make above WACC returns on providing these services and thus it is in BT's commercial interests to provide these services. If degradation is a genuine risk (as Openreach claim) then the appropriate response is not permitting excessive prices that allow supra-normal profits but SLAs, SLGs and possibly a minimum service level (backed up be enforcement)[4].

1.12 Regarding incentives on CPs to invest in diagnostics, Openreach suggests that if Openreach TRC/SFI products prices are reduced it will reduce the incentive on CPs to invest in diagnostics (§13, §43). It must be recognised that CPs already have a very strong incentive to invest in their own diagnostics in order to avoid the cost and inconvenience of unnecessary engineering visits, particularly those where CPs rely on Openreach whose prices are so high. Reducing the prices of SFI/TRCs will reduce the incentive on CPs to invest but CPs will still have incentives for *efficient* investment. Arguably, when SFI/TRC prices are set so far above cost, CPs will be over-investing (i.e. investing so heavily so as to lead to reductions in allocative efficiency).

1.3 Genuinely contestable SFIs and TRCs

1.13 We accept that some SFI and TRC service (such as some 'volume deals') are genuinely contestable (though not as great a proportion as Openreach suggests). We think that the appropriate approach to price regulation to reflect this is to exempt these services from price regulation (i.e. one element of what is proposed in option 2) rather than raising the prices of all SFI/TRCs. There are several reasons for this:

- It ensures that regulation is targeted where it is needed and not applied where it is not rather than applying an 'average' approach (which will result in too much regulation in some areas and too little elsewhere)
- It does not require Ofcom to make an arbitrary and difficult to evidence assumption about what the appropriate EBIT margin is for contestable services

1.14 For the avoidance of doubt we do not agree with other elements of Openreach's option 2 – for instance, as we explain above new products must be price regulated at FAC.

1.4 Cost / price estimates

1.15 Openreach argue that the overhead uplift should be 67% and not 48% (§85). We have a number of comments on this:

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[4] Such SLAs, SLGs, minimum service levels would have to be set in terms of appointment availability and, in some case, job completion since there is no single broadband quality standard that needs to be met (like SIN349 for normal repairs)

- This level of overhead (which we assume reflects the non-field engineer cost as a % of field engineer cost) appears very high based on our internal experience
- It is not clear why the 67% figure should be preferred over the 51% "*overhead figure that Openreach provided based upon the 2012/13 RFS*" since the 51% figure seems the appropriate and reliable figure to use
- Any adjustment would if appropriate, we imagine, only affect the cost estimates (and required price reductions) based on management accounts[5] and not the ones derived from the RFS or those based on Qube cost benchmarks. For the avoidance of doubt, we continue to believe that the Qube benchmark is the most appropriate basis on which to set prices

1.16 We do not support Ofcom setting prices above FAC. However, if Ofcom decide to do so then any above FAC recovery must be offset with below FAC recovery elsewhere. In other words, allowing prices for SFIs and TRCs above FAC must not lead to over-recovery but rather a shifting of (common) cost recovery between different products.

1.5 Reporting

1.17 Openreach complain (at §§74*ff*) at the amount of data that it will be required to report. We consider that the following data is necessary at a minimum:

- Data sufficient to demonstrate compliance with the charge control (which will probably relate primarily to prices, not costs)
- Data on the *total* costs of providing services that can be used to set the next charge control. This should be provided as part of the RFS (which will ensure that there is no under- / over-recovery of costs). We see no reason (provided the RFS are robust) as to why the RFS should not be used as the starting point to determine SFI/TRC costs (as for other WLA products) in the next charge control
- Some breakdown of the revenue, costs by service and cost component to, for example, better understand the cost levels, level of incremental cost, overall margins and margins across products. This data will help inform decisions in the next charge control

[5] These are referred to as 'Method 1' and 'Method 2' in TalkTalk's response on SFI/TRCs (February 2014)