



A new pricing framework for Openreach

Statement

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Section 1

Summary

Introduction

- 1.1 In May 2008, we published a consultation document, “A New Pricing Framework for Openreach” (the “First Consultation”). This set out our intention to review certain aspects of the regulatory regime, including the prices of the regulated access network services; certain other access and backhaul services are covered by the separate Leased Line Charge Control review. The scope of this review included the prices for WLR, MPF and SMPF rentals (the “Core Rental Services”) and related services.
- 1.2 In December 2008, we published a range of proposals for modified price controls (the “Second Consultation”). The Second Consultation set out the key assumptions and parameters we proposed would be taken into account in reaching our final conclusions on any new price controls. In particular, we invited views on the methodology and assumptions used in arriving at these proposals. Informed by responses received during this consultation, we are now setting prices for MPF and SMPF. This Statement sets out these prices and the bases for the underlying calculations including our impact assessment.
- 1.3 In response to the Second Consultation, the European Commission recommended that we delay implementation of new WLR prices until the outcome of the ongoing Wholesale Narrowband Market Review is known. In light of this recommendation, we have not determined new prices for WLR at this stage.
- 1.4 If, as we propose in the Wholesale Narrowband Market Review Consultation, we find that there is still a need for WLR price controls, we would expect to set new prices later this year. We will shortly be publishing a consultation document setting out our proposals for these prices. To a significant extent, these will draw upon the analysis summarised in this Statement.
- 1.5 As well as the Core Rental Services, Openreach provides a range of other services, related to the provision of the MPF and SMPF rental services. These are currently subject to price control and/or cost orientation obligations. In the Second Consultation, we proposed that these services should be subject to price controls applied to appropriately defined baskets. This Statement sets out our determination of the appropriate design of these baskets and the related controls.

The Second Consultation

- 1.6 In December 2008, we set out proposed ranges for the new controls. They comprised two elements: the proposed price ceilings for 2009/10 and the proposed indexation of the ceiling for the MPF and SMPF services in 2010/11.
- 1.7 We explained that the final combination of 2009/10 charge and subsequent indexation in 2010/11 would be determined such that – if an equivalent annual indexation were to apply until 2012/13 - it would deliver a price that equals our final assessment of the projected efficient fully allocated cost of each service in the final year. For the purposes of illustration, we calculated the proposed indexation ranges for 2010/11 indexation assuming that these would start from the mid-point of the respective range for the proposed 2009/10 charges. The illustrative indexation

ranges were estimated such that – if applied to this mid-point starting charge – they would allow prices to approach fully allocated costs by 2012/13.

- 1.8 On this basis we proposed the following combination of 2009/10 charges and subsequent indexation in 2010/11.

Table 1.1: Proposals from Second Consultation

Service	Current price cap	Proposed price from 1 April 2009	Proposed indexation on 1 April 2010
MPF rental	£81.69	£85.00 to £91.00	RPI + 0.0% to RPI + 5.0%
SMPF rental	£15.60	£15.60 to £16.20	RPI - 2.5% to RPI + 1.5%
WLR residential rental	£100.68	£100.68 to £104.40	See paragraph 1.10
WLR business rental	£110.00	£106.00 to £110.00	See paragraph 1.10

- 1.9 We proposed that the LLU charge controls would apply for a period of two years. The period would ensure charges were appropriate for the period leading up to the completion of the next Wholesale Local Access Review at which time the future requirement for LLU and related charge controls would be determined. We confirmed the appropriateness of a modification of the LLU controls in the absence of the recent Market Review through a determination that the market had not experienced a material change since the last Market Review.
- 1.10 We also explained that the ongoing Wholesale Narrowband Market Review would consider whether the WLR remedy was still necessary in the longer term. On this basis, we did not propose price changes beyond 2009/10.
- 1.11 Our proposals were set out in ranges. We set out how we would finalise the controls based on a number of factors discussed in the consultation.
- 1.12 We also explained that there were significant uncertainties surrounding the short term macro-economic outlook and capital markets continued to exhibit unusual levels of volatility. We explained that setting new price controls in this context is challenging and we recognised the possibility that certain eventualities (such as general price deflation) may present unforeseen challenges that might necessitate review of the controls that we may set following the consultation.

Recent developments

- 1.13 We received 14 responses to the Second Consultation. These are listed in Annex 11. We have published non-confidential responses on our website¹. As set out in this Statement, responses included comments on the following:
- The appropriate approach to setting prices, including the appropriateness of fully allocated costs as the basis for setting charges;

¹ <http://www.ofcom.org.uk/consult/condocs/openreachframework/responses/>

- The underlying assumptions to be used in our cost modelling, including the need to take account of recent economic developments;
 - The implications of the proposed price changes, including the impact of price changes on consumers;
 - The appropriate notice period ahead of any price changes; and
 - The level of transparency provided by the December Consultation.
- 1.14 The responses included comments from the European Commission as part of the community-wide consultation which ran in parallel with the national consultation. As noted above, this included a recommendation that we delay implementation of new WLR prices until we have concluded the ongoing Wholesale Narrowband Market Review is known. The Commission also invited us to re-notify our final decision setting the regulated wholesale prices and price caps for LLU. We have decided not to take up this recommendation for reasons set out later in this statement (see Section 2).
- 1.15 This Statement sets out how we have taken these responses into account in making our final decisions on prices.
- 1.16 The economic uncertainty observed in December still prevails. General price deflation (as measured by the retail price index) now looks likely in the short term and commodity prices have fallen. Stakeholders, including BT and Sky have made public announcements regarding their intentions regarding their future use of MPF and we now have better visibility of Openreach's financial projections and operating plans for in 2008/09 and 2009/10. We have taken account of this new information in setting the new price controls. As explained in this Statement, the impact of these developments has been to reduce our estimates of the likely cost of providing the services in 2009/10.

New prices

- 1.17 Informed by the responses to our consultations, we have set new price controls for the MPF and SMPF rental services. As proposed, these controls comprise two elements: price ceilings for 2009/10 and indexation of the ceiling for the services in 2010/11. We do not consider it is appropriate to set charges beyond two years as this would extend the controls beyond the expected review of the requirement for LLU within the Wholesale Local Access Review.
- 1.18 As proposed in the Second Consultation, we have determined a combination of 2009/10 charge and subsequent indexation in 2010/11 such that – if an equivalent annual indexation were to apply until 2012/13 - it would deliver a price that equals our assessment of the projected efficient fully allocated cost of each service in the final year.
- 1.19 Historically, linking prices to RPI has provided protection for all parties against unexpected movements in inflation. To provide this protection the RPI data needs to provide a relevant measure of the cost pressures facing the supplier during the period in which the price control is to apply. However, it must also provide a workable approach. In practical terms, this means it must be based on historical published data. For the purposes of the indexation in 2009/10, the RPI data will be for October 2009.

- 1.20 As explained in this Statement, we note that the October 2009 RPI is unlikely to provide a reliable indicator of the inflationary pressure facing Openreach for the relevant period. Specifically, the October RPI data is likely to show a much lower level of reported inflation than we consider should be used in setting the 2010/11 control due to the impact of changes in VAT and mortgage interest rates on the reported RPI. The values of the Xs set out below have therefore been adjusted to allow for this bias. The effect of this adjustment has been to increase the values of the Xs in 2010/11 by approximately 4%.

Table 1.2: New controls on MPF and SMPF

	Current price	Price in 2009/10	Indexation in 2010/11
MPF	£81.69	£86.40	RPI +5.5%
SMPF	£15.60	£15.60	RPI +1.0%

- 1.21 BT is free to implement these charges 28 days from 22 May 2009.
- 1.22 Until the conclusion of the Wholesale Narrowband Market Review and the related review of the WLR charge control, the prices for residential and business WLR rental services will remain at their current levels, of £100.68 and £110.00 respectively.
- 1.23 The price controls to be applied to the baskets of other services are described in detail in Section 6 and summarised in Table 1.3. These are described in two parts: the allowable indexation in 2009/10 and the indexation on 1 April 2010. Only the indexation for 2010 is linked to RPI. The baskets also include some one-off adjustments to MPF new provide, MPF and SMPF connection charges.

Table 1.3: New controls on Ancillary Services

Service	Indexation in 2009/10	Indexation on 1 April 2010
MPF ancillary services	3.0%	RPI +4.5%
SMPF ancillary services	3.0%	RPI +4.5%
Co-mingling services	3.0%	RPI +4.5%

- 1.24 New prices on these services can be implemented under existing regulatory rules on notification, that is, 90 days after BT gives notification of any proposed changes.

Ongoing review

- 1.25 We explained in December that, in light of the ongoing economic uncertainty, we recognise the possibility that certain eventualities may present unforeseen challenges that necessitate review of the controls that we may set following the consultation. As proposed in December, we will closely monitor the effectiveness of our new controls, and intervene if such circumstances require. However, we

recognise that such intervention is not without risk and potentially introduces an additional level of uncertainty. Such intervention will be at our discretion and will not be based on any automatic trigger mechanism.

- 1.26 Also as explained in this statement, our cost calculations exclude Openreach's share of annual payments made by BT to address the funding shortfall in its pension scheme. While this approach is consistent with our historic treatment of pension deficits and surpluses, we consider that this issue is of increasing importance to the companies we regulate. Accordingly, we propose to undertake a separate review of our treatment of pension costs which will inform our future approach.

Section 2

Scope and policy objectives

Introduction

2.1 This Section explains the services and products falling within the scope of this review. It describes how our review fits in with other ongoing projects undertaken by Ofcom and sets out the policy objectives pursued in this review.

Scope of review

Services and products reviewed

2.2 Our proposals concern the regulated copper based access services provided by BT Group plc ('BT') through its functionally separate business called Openreach. Openreach was established in 2005 as result of BT offering, and Ofcom accepting, a set of undertakings ('the Undertakings') pursuant to section 154 of the Enterprise Act 2002.

2.3 Openreach provides wholesale access services—essentially, Wholesale Line Rental ('WLR'), Local Loop Unbundling ('LLU') and Ethernet access—to all communications providers (including BT and its competitors) on an equivalent basis under the Undertakings. Those services fall within markets in which BT has been determined to have significant market power ('SMP'). They therefore fall to be regulated by Ofcom by means of sector specific regulation (known as SMP conditions) under the Communications Act 2003 ('the Act'). This regulation is subject to a harmonised framework for the regulation of electronic communications services, networks and associated facilities and services, as contained in a package of directives adopted under the EC Treaty.²

2.4 As a result of SMP determinations, BT is currently subject to a number of SMP conditions, including price controls and cost orientation obligations in relation to WLR and LLU. Specifically, the remedies already imposed on BT include:

- charge ceilings for the key LLU and WLR services;
- cost orientation obligations for other LLU and WLR services; and
- other SMP obligations requiring no undue discrimination, price publication and the public provision of audited regulatory accounts.

2.5 For ease of reference in our review, we divided the services provided by Openreach into four categories, as follows:

- **“Core Rental Services”**, which include the WLR, MPF and SMPF rentals;

² Three directives are particularly relevant in this context: (a) Directive 2002/21/EC of 7 March 2002 on a common regulatory framework for electronic communications networks and services (the 'Framework Directive'); (b) Directive 2002/20/EC of 7 March 2002 on the authorisation of electronic communications networks and services (the 'Authorisation Directive'); and (c) Directive 2002/19/EC of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities (the 'Access Directive').

- **“Ancillary Services”**, which include the related services in the markets where SMP has been found. These can be further divided into three sub-categories, as follows:
 - SMP services that are subject to price controls;
 - SMP services that are subject to cost orientation obligations; and
 - SMP services that are not subject to cost orientation obligations.
- **“Non-Regulated Services”**, which include the related services that are not subject to a finding of SMP; and
- **Services covered by the Business Connectivity Market Review** (which are outside the scope of this review).

2.6 The calculations for the current charge controls predate the creation of Openreach. Fixed charge ceilings for WLR and LLU services were set as follows:

- the current ceilings for residential WLR (£100.68) and business WLR (£110.00) were set in the 24 January 2006 Statement, “Wholesale Line Rental: Reviewing and setting charge ceilings for WLR services“;
- the current ceiling for MPF (£81.69) was set in the 30 November 2005 Statement, “Local loop unbundling: setting the fully unbundled rental charge ceiling and minor amendment to SMP conditions FA6 and FB6“; and
- the current ceiling for SMPF (£15.60) was set in the 16 December 2004 Statement, “Review of the Wholesale Local Access Market“.

2.7 As explained in the Second Consultation, this review has considered the cost of providing the Core Rental Services and all Ancillary Services, and the allocation of costs across all services, including the Non-Regulated Services. We have, however, only set charge controls for the regulated LLU services in this Statement.

Links to other projects

2.8 We have recently undertaken, or are currently undertaking, a number of reviews which are closely linked to the markets for narrowband and broadband access that are relevant to services and products within our review. Those reviews include:

- *The Fixed Narrowband Wholesale Service Market Review (“Narrowband Market Review”)*. This review is considering the wholesale fixed narrowband markets, including the specific markets for exchange lines, call origination and call termination in the UK. In 2003, BT was found to have SMP in each of those specific markets and as a consequence one of the remedies imposed was a requirement on BT to provide WLR. On 19 March 2009, Ofcom published its consultation document setting out our provisional findings in relation to those markets, including that BT has SMP in the market wholesale analogue exchange line services in the UK except the Hull Area and that WLR remains a required remedy.³

³ See consultation document entitled “Review of the fixed narrowband services wholesale markets”; http://www.ofcom.org.uk/consult/condocs/review_wholesale/fnwm.pdf.

- *WLR Charge Control.* In the Second Consultation, we proposed price changes for WLR rental charges in the short term, with a view to considering the potential requirement for the continuation of the WLR remedy in the longer term and any associated charge control, as part of the Narrowband Market Review. While we have now proposed in the Narrowband Market Review that a charge control is appropriate and proportionate in relation to the nature of the problems identified in the market analysis, we are no longer proposing to impose immediate changes to WLR rental charges as part of this Statement. For reasons set out below, we have decided to consult separately on the WLR charge control, including on the elements of the WLR analogue service to be covered by the charge control and the basket design, in light of the market analysis we have carried out. We expect to publish the WLR charge control consultation shortly and to reach our conclusions by October 2009.
- *The Wholesale Local Access Market Review (“WLA”).* In the Second Consultation, we explained that we are expecting to begin our review of the Wholesale Local Access market this year and to complete it in 2010. The WLA will consider the market conditions for the access line to residences and businesses. BT currently holds SMP in the WLA market in the UK excluding the Hull Area and LLU remedies (SMPF and MPF services) were imposed as result of that finding in December 2004. Meanwhile, we set out in the Second Consultation our assessment of the current market conditions taking into account expected or foreseeable market developments until such further market analysis has been carried out by Ofcom. As a result, we explained that we were satisfied that there has not been a material change in that market since the SMP finding was made, although certain developments had taken place impacting on the appropriateness of the current charge ceilings, which are fixed in nominal terms and unlimited in their duration.
- *The Leased Lines Charge Control.* In the Business Connectivity Market Review (“BCMR”), Ofcom considered the markets for wholesale symmetric broadband origination services, including Ethernet-based (or “alternative interface”) services. These include BES services which are the key backhaul products supporting LLU. On 8 December 2008, we published our BCMR statement⁴ finding that BT has SMP in the relevant market for these services and concluded that, in principle, BT should be subject to a charge control, the specific proposals of which are subject to a separate consultation.⁵

2.9 We noted in the Second Consultation that there are differences in the modelling approach between this Openreach review and the Leased Lines Charge Control reflecting the differences in the services under review. Specifically, as the LLU and WLR services make up the bulk of the Openreach operations, we explained that we had chosen to model the totality of Openreach costs drawing on Openreach planning information. However, as Leased Lines operations cut across most of the operational elements of BT, the identification of relevant costs and their relationship required the development of a unique model of unit costs.

⁴ See statement entitled “Business Connectivity Market Review”; <http://www.ofcom.org.uk/consult/condocs/bcmr08/bcmr08.pdf>.

⁵ See consultation document also published on 8 December 2008 and entitled “Leased Lines Charge Control”; <http://www.ofcom.org.uk/consult/condocs/lcc/leasedlines.pdf>.

Responses to the Second Consultation

- 2.10 Stakeholder responses included broad support for the scope of our review. Vodafone noted the need for us to consider the core LLU and WLR services in the wider context of Openreach's overall costs in order to ensure that cost allocations are appropriate.
- 2.11 The Federation of Communication Services provider ('FCS') noted the need to focus on the total cost of ownership and the need to ensure that the ancillary costs do not distort that cost. We accept the need to do this which is why we have increased the range of services covered in the ancillary service baskets for LLU as further discussed in Section 6.
- 2.12 Some stakeholders suggested that it may be appropriate to delay changes to the controls until after the completion of the next round of relevant Market Reviews. As discussed below, we have accepted this point with respect to the WLR services but we consider that to delay changes to the LLU charges for up to 24 months would be inappropriate given the need to ensure that MPF prices do not fall too far out of line with the underlying costs. We rely on our no material change assessment of the LLU market as a re-assurance that modifications to the LLU conditions in accordance with the cost analysis are appropriate at this time.
- 2.13 Some stakeholders suggested that the scope of our review could have been used to consider a wider set of questions. In particular, Scottish and Southern Electricity ('SSE') suggested that the review might have considered how the proposed new pricing framework could be used to incentivise Openreach to improve its processes for product development and also how stakeholders could be more engaged in future investment.
- 2.14 We accept that there are issues surrounding the prioritisation of Openreach's new product development. We are addressing these issues as part of the discussions led by the OTA around the proposed changes to the BT Undertakings commitments. We expect to consult on the new priorities and approach for product development as well as other changes to BT's Undertakings commitment in the near future.

Comments by the European Commission

- 2.15 As noted above, our proposals fall within the harmonised Community regulatory framework under the relevant EC Directives. In addition to national consultation, Ofcom therefore notified its proposals under Article 7(3) of the Framework Directive to the European Commission and other national regulatory authorities ('NRAs') in other member states. This Article 7 process is important as it aims at contributing to the development of the internal market in telecoms by NRAs co-operating with each other and the Commission in a transparent manner to ensure the consistent application of the Directives.
- 2.16 To that end, Article 7 requires that NRAs:
- carry out their tasks under the Directives by taking the utmost account of the policy objectives set out in Article 8 of the Framework Directive; and
 - take utmost account of any comments made by other NRAs and the Commission during the consultation, although the NRA intending to adopt the draft measure in question may nonetheless adopt the resulting draft measure.

- 2.17 We received no comments from other NRAs, but the Commission commented by inviting Ofcom in particular:
- to adopt the final measure with regard to WLR prices only once it has finished its review of the Narrowband Market Review; and
 - to re-notify its final decision setting the regulated wholesale prices and price caps for LLU to the Commission.
- 2.18 As noted above, we are no longer proposing to impose immediate changes to WLR rental charges as part of this Statement. We noted in the Second Consultation that the completion of the Narrowband Market Review and any decision on the continued requirement for a WLR remedy was necessary before we considered it appropriate to set a new price control. We proposed, however, immediate adjustments of the WLR rental charges as we were concerned that the evidence was pointing to the existing charges being out of alignment with the costs.
- 2.19 Our view is now that there is no immediate requirement to adjust WLR rental charges prior to the completion of the Narrowband Market Review and we have therefore decided not to proceed with those specific proposals as part of this Statement. This is especially the case since, as we discuss in this Statement and will address in the consultation on WLR charges planned for early next month, our current view is that the existing charges are sufficient to cover existing costs. This follows our consideration of responses received, recent developments and further analysis. We, therefore, consider the need for immediate adjustments to WLR charges to be of less importance than at the time we published the Second Consultation. This deferment also allows comprehensive consideration of the effectiveness and appropriateness of the structure of the remedies in light of the market analysis, to which the Commission refers in its comments.
- 2.20 However, given the need to consider and fully establish the cost of all copper based services within Openreach, we will in effect largely be determining WLR costs in the establishment of the LLU costs and charges in this Statement and then draw on this cost information for the purposes of making our proposals in the WLR Charge Control consultation. This approach is also consistent with the need to ensure that WLR and LLU charges are consistent in terms of their coverage of common costs and their relative difference when compared to incremental costs. We will address this issue in more detail in the WLR charge control consultation.
- 2.21 In respect of the Commission's invitation to Ofcom about re-notifying final LLU prices, we note that the Commission considers that Ofcom's approach to notify only broader possible price ranges and not the exact rates and price caps proposed to be applied by Openreach may compromise the objective of the Community consultation, by not allowing the Commission and other NRAs to assess the draft decision and to comment on it in the full knowledge of the facts and the economic context.
- 2.22 We have considered the Commission's comments carefully. We have, however, decided to adopt our decision without re-notifying to the Commission and other NRAs under Article 7(3) of the Framework Directive.
- 2.23 It is very important to Ofcom that we take decisions at the right time and in the right way. Consultation plays an important part in achieving this and offers stakeholders the opportunity to inform our final decision. We therefore recognise the need to provide sufficient information and clarity of our proposals to enable all stakeholders to

make effective and intelligent responses. The extent and method of consultation must also depend on the circumstances of each case.

- 2.24 Nevertheless, we consider that the ranges proposed in the Second Consultation were sufficiently narrow to enable stakeholders to comment in light of the significant amount of information and data published in the Second Consultation.
- 2.25 Moreover, we explained the most basic features of proposed LLU price changes by clearly setting out the factors that we would apply in assessing final charges within each respective range. For example, in Section 5 of the Second Consultation, we set out our views on key assumptions that would be likely to have an impact on final charges and specifically drew attention to ‘estimates’ or ‘ranges’ on which we were consulting. We have, therefore, reached our final view on the appropriate assumptions as informed by responses to the consultation and reaching a final position on the underlying assumptions which reflect current market conditions.
- 2.26 In reaching this view on the Commission’s invitation, we have also taken the utmost account of the policy objectives set out in Article 8 of the Framework Directive. In particular, we consider that there is an immediate need to act by replacing existing fixed nominal charge ceilings imposed on BT with a new control on BT’s prices that allows it to efficiently recover its costs now and to ensure investment is undertaken on the basis of appropriate information. We are aware that a number of stakeholders are poised to consider MPF investment and continued delay and uncertainty could threaten or distort this. Any delay to correct this position would, in our opinion therefore, have negative consequences for BT and other stakeholders derived from the continuing uncertainty as well as the financial impact on BT. It could therefore jeopardise the attainment of the relevant policy objectives further discussed below, including safeguarding competition, protecting the interests of users and discouraging investment.
- 2.27 We also consider that consultations on price ranges do not, in principle, compromise the objective of the Community consultation, provided that there is sufficient clarity and information of the factors that will be taken into account in reaching the final charges and the impact of the proposals are explained. We also note that we have in the past notified to the Commission a number of draft measures involving a proposed range for the values of X, without the Commission making any comments on this approach.⁶

Policy objectives

Section 3 – Ofcom’s general duties

- 2.28 Under the Act, our principal duty in carrying out functions (such as making the present proposals) is to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.
- 2.29 In so doing, we are required to secure a number of specific objectives and to have regard to a number of matters, as set out in section 3 of the Act. As to the prescribed specific statutory objectives in section 3(2), we consider that the objective of securing

⁶ Cases include the Commission’s comments on UK/2005/0165: Revised remedies related to cases UK/2003/0012, 0016 and 0003 (concerning Ofcom’s revised network charge controls applying to BT in 2005); and very recently in February 2009 on UK/2008/0859: wholesale terminating and trunk segments of leased lines – charge control obligation (i.e. the Lease Line Charge Control consultation).

the availability throughout the UK of a wide range of electronic communications services objectives as particularly relevant to this consultation.

- 2.30 In performing our duties, we are also required to have regard to a range of other considerations, as appear to us to be relevant in the circumstances. In this context, we consider that a number of such considerations are relevant, namely:
- the desirability of promoting competition in relevant markets;
 - the desirability of encouraging investment and innovation in relevant markets; and
 - the desirability of encouraging the availability and use of high speed data transfer services throughout the United Kingdom.
- 2.31 We have also had regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed, as well as the interest of consumers in respect of choice, price, quality of service and value for money.
- 2.32 Ofcom has, however, a wide measure of discretion in balancing its statutory duties and objectives. In so doing, we have taken account of all relevant considerations, including responses received during this consultation process, in reaching our conclusions.

Section 4 – European Community requirements for regulation

- 2.33 As noted above, our proposals involve Ofcom exercising functions falling under the EU regulatory framework. As such, section 4 of the Act requires us to act in accordance with the six European Community requirements for regulation.
- 2.34 In summary, these six requirements are:
- to promote competition in the provision of electronic communications networks and services, associated facilities and the supply of directories;
 - to contribute to the development of the European internal market;
 - to promote the interests of all persons who are citizens of the European Union;
 - to take account of the desirability of Ofcom's carrying out of its functions in a manner which, so far as practicable, does not favour one form of or means of providing electronic communications networks, services or associated facilities over another, i.e. to be technologically neutral;
 - to encourage, to such extent as Ofcom considers appropriate for certain prescribed purposes, the provision of network access and service interoperability, namely securing efficient and sustainable competition and the maximum benefit for customers of communications providers;
 - to encourage compliance with certain standards in order to facilitate service interoperability and secure freedom of choice for the customers of communications providers.

2.35 We considered in the Second Consultation that the first and fifth of those requirements were of particular relevance to our proposals and that no conflict arises in this regard with those specific objectives in section 3 that we consider are particularly relevant in this context. We remain of that view.

Our objectives for this review

2.36 Informed by stakeholder responses to the First Consultation, we set out our updated specific policy objectives for this review in the Second Consultation, as follows:

- to promote efficient and sustainable competition in the delivery of both broadband and traditional voice services;
- to provide regulatory certainty for both Openreach and its customers and to avoid undue disruption;
- to ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide Openreach with the opportunity to recover all of its relevant costs (where efficiently incurred), including the cost of capital; and
- to maintain incentives for Openreach to innovate and improve service quality.

2.37 All stakeholder responses supported the objectives set out above, though Openreach emphasised that the recovery of efficiently incurred costs should be achievable within a given control period – an issue which we will again consider in Section 5 of this Statement.

2.38 The CBI suggests that a quick decision should be considered an objective in its own right as it provides the certainty required by businesses.

2.39 Another stakeholder (who provided a confidential submission) suggested that two additional objectives should be included:

- to minimise costs for CPs and, thereby, keep prices as low as possible for end users; and
- to encourage the efficient growth of broadband service penetration in the UK.

2.40 We consider that these objectives are already largely captured within our initial set. Growth of broadband must be based on efficient levels of investment which is in turn linked to charges set at an appropriate level for BT and CPs. We do, however, accept that explicit references to end-users or consumers were absent from our original list of objectives. Ultimately, the objective of promoting competition is to ensure that we can maximise consumer outcomes in terms of price and service – we address this in our analysis of the impact of price changes.

2.41 Tiscali raised the possibility of on-going review of the assumptions underpinning the decisions. We accept that it is desirable to have charges as closely as possible reflect the actual costs at all times, but note that frequent reviews can also undermine the promotion of competition, investment and innovation as regulatory certainty can be undermined. Given our expectation to complete the WLA market review by 2010 (including a review of the LLU charges), we do not consider that a scheduled mid point review is justified.

- 2.42 Accordingly, we have adopted these policy objectives, which we consider are consistent with the duties and objectives under sections 3 and 4 of the Act (as discussed above), in reaching our conclusions on the final LLU charges.

Our impact assessment

- 2.43 The analysis presented in the rest of the Sections and Annexes of this Statement represents an impact assessment, as defined in section 7 of the Act.
- 2.44 Impact assessments provide a valuable way of assessing different options for regulation and showing why the preferred option was chosen. They form part of best practice policy-making. This is reflected in section 7 of the Act, which means that generally Ofcom has to carry out impact assessments where its proposals would be likely to have a significant effect on businesses or the general public, or when there is a major change in Ofcom's activities. However, as a matter of policy Ofcom is committed to carrying out and publishing impact assessments in relation to the great majority of its policy decisions. For further information about Ofcom's approach to impact assessments, see the guidelines, Better policy-making: Ofcom's approach to impact assessment, which are on the Ofcom website:
http://www.ofcom.org.uk/consult/policy_making/guidelines.pdf
- 2.45 Specifically, pursuant to section 7, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the Act) is secured or furthered by or in relation to what we propose.
- 2.46 We received consultation responses on specific issues raised by our impact assessment and we set out our consideration of them in the appropriate places in this Statement.

Section 3

Recent developments

Introduction

- 3.1 We explained in the Second Consultation that we are setting new controls at a time of significant short term economic uncertainty. This uncertainty remains. There have also been significant economic and commercial developments that are relevant to this review.
- 3.2 In their responses to the Second Consultation, several respondents stated that the new controls must reflect these recent events.
- 3.3 This Section provides a short update on these recent developments and how we have taken them into account in setting the new controls.

Market developments

- 3.4 Informed by stakeholder responses to the First Consultation, we explained in the Second Consultation that there have been significant positive changes to the nature of the telecommunications market since 2005 as a result of the creation of Openreach, the associated undertakings and charge controls and the gradual improvement in Openreach's service delivery. Together these factors have allowed a range of competitors to enter the market offering differentiated, competitively priced propositions to the benefit of consumers.
- 3.5 We noted that stakeholders' views varied as to the sensitivity of the market to price changes in the current framework. We concluded that, while WLR and LLU pricing may not be the only factor influencing decisions on future investment, it is an important aspect of that decision. Stakeholders also highlighted the need to ensure that the pricing framework provides appropriate price signals to investors and to consumers. The framework must be sustainable and ensure that future investment is efficiently made.
- 3.6 In their responses to the Second Consultation, stakeholders confirmed our assessment of the importance of the existing charges and wholesale regulations to the growth of telecommunications services. For example, in its response to the Second Consultation, Network Automation noted that we are only at the beginning of this growth and that demand will increase including a requirement for higher services levels.

Other developments

- 3.7 Several respondents referred to recent changes in the key parameters that underpinned our December proposals – such as inflation and commodity costs – and stated that we must take these changes into account when reaching our decision. For example, Sky stated that:

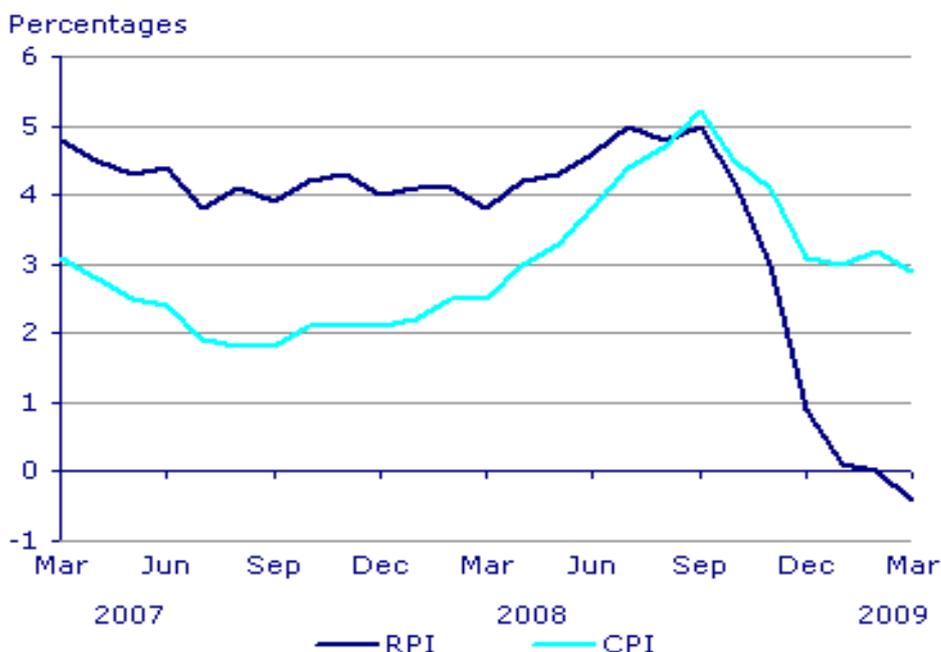
“The world has changed dramatically in the period since Ofcom carried out its analysis. Five months ago the world was concerned about a scarcity of natural resources and increasing inflation; since then inflation expectations and commodity prices have fallen to historically low levels. As an evidence-based regulator, Ofcom

should (and, in fact, has a duty to) take these changes into account in its analysis as they are likely to have a very material impact on Openreach’s overall level of costs.”

3.8 We agree that our analysis should take account of the best information available to us at the time our decision is made, including recent economic and stakeholder news.

3.9 As illustrated by Figure 3.1, inflation – as measured by RPI and CPI - has fallen and RPI deflation in the short term is now a reality.

Figure 3.1: RPI / CPI



Annual inflation rates - 12 month percentage change

Source ONS

3.10 Some cost categories – such as energy costs - have fallen below the level reflected in the calculations set out in the Second Consultation.

3.11 As illustrated by Figure 3.2, the price of copper - which represents a significant proportion of Openreach’s asset base and therefore impacts on the annual depreciation charge and the appropriate level of return on those assets – is also much lower than it was and is significantly less than was reflected in our earlier calculations.

Figure 3.2: Copper price movement since April 2005



Source: London Metal Exchange (Cash buyer prices)

3.12 Since December, stakeholders have also made announcements that need to be reflected in our calculations. For example:

- In January, Sky announced its plans to migrate its customers to MPF which they expect to complete over the next two years;
- In late December, BT announced the suspension of its plans for the new NGN related access services, specifically the Wholesale Voice Connect (WVC) and Wholesale Broadband Connect Converged (WBCC). As explained in Annex 7, this will significantly reduce the likely level of demand for MPF from within BT.
- BT has recently announced new cost saving programmes, including a pay freeze announced on 11 March.

3.13 The significance of these developments and their implications for the new prices is described within our review of the financial evidence in Section 4.

Section 4

Review of the financial evidence

Introduction

- 4.1 In the Second Consultation, we set out our view on the financial case for price changes for the Core Rental Services based on our assessment of the unit costs for each of those services, and the assumptions taken into account in making those projections.
- 4.2 We invited stakeholders' views on the cost calculations and the underlying assumptions.
- 4.3 Informed by responses to the Second Consultation and the recent developments summarised above, this Section sets out our final calculations of the unit costs of the Core Rental Services based on updated assumptions.
- 4.4 In response to stakeholders' comments, Annex 6 sets out why we are satisfied that our approach to these calculations provides a robust basis for our analysis, including an explanation of why:
- the starting point for the cost modelling is robust;
 - it is appropriate to use a four year period as the basis for modelling future costs; and
 - the results appear reasonable.
- 4.5 In Annex 6, we also respond to comments from some stakeholders regarding the level of transparency of financial information during this consultation process.

Background

- 4.6 As explained in the Second Consultation, we consider that Fully Allocated Current Cost Accounting ("CCA FAC") principles provide the most practical, appropriate basis for determining the cost of providing the services within the scope of this review. As explained in Section 5 of this Statement, this approach was challenged by the Talk Talk Group ("Talk Talk"). However, for the reasons given in Section 5, we are satisfied that this continues to provide the most appropriate approach for the purpose of this set of controls.
- 4.7 We explained in the Second Consultation that, at our request, Openreach provided cost and revenue projections for the Core Rental Services in the period to 2012/13, as set out in Table 4.1. The projections were derived from a model built by Openreach for its own planning purposes. The key relationships reflected in the model are used to inform Openreach's planning decisions and are based on activity data.

Table 4.1: Openreach estimate of CCA costs and revenues for Core Rental Services, assuming prices remain fixed in nominal terms (as at December 2008)

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	07/08-12/12
	£'m	£'m	£'m	£'m	£'m	£'m	CAGR
Revenue	2,687	2,670	2,660	2,488	2,249	2,091	-4.9%
Pay	541	572	572	576	601	597	2.0%
Line cards and TAMS	274	273	270	233	158	99	-18.5%
Accommodation	273	281	300	308	317	326	3.6%
Stores, contractors & misc	156	139	136	135	134	133	-3.1%
Corporate Overheads	101	104	103	99	103	105	0.8%
IT	138	143	137	133	138	140	0.3%
Fleet	87	90	89	92	93	95	1.6%
Other	66	58	62	54	42	36	-11.2%
Operating cost	1,636	1,659	1,669	1,629	1,587	1,531	-1.3%
EBITDA	1,051	1,012	991	858	662	560	-11.8%
Depn	329	403	458	508	559	599	12.7%
EBIT	722	609	532	350	103	-39	-155.8%
ROCE %	10%	9%	7%	5%	1%	0%	
Mean Capital Employed	7,056	7,047	7,343	7,534	7,700	7,821	2.1%

4.8 As explained in the Second Consultation, we considered that, overall, Openreach's approach to its cost calculations appears to be logically sound. Indeed, we consider that there are significant advantages of using cost estimates derived from a model used by Openreach for its own planning purposes.

4.9 As explained in Annex 6, we remain satisfied that our approach to modelling Openreach's costs provides an appropriate basis for estimating Openreach's future costs. We remain of the view that Openreach's own view of future costs, if appropriately challenged and adjusted, potentially provides more relevant data with which to start our own analysis of costs in the period to 2013 than audited regulatory accounting information for a 12-month period that started in 2007.

4.10 As explained in the Second Consultation, we assessed the integrity of Openreach's models. Specifically, we:

- spent significant time with Openreach and its consultants to ensure that we fully understand the mechanics of the model;
- reviewed model user manuals and obtained thorough explanations of key aspects of the model;
- tested the interaction of volumes, task times, FTE assumptions, average salaries, fault rates and visit ratios to ensure the models produced predictable outputs that could be understood;
- reviewed the allocation bases, to ensure that they are reasonable and are applied as described;
- reconciled the base year forecasts back to audited financial data; Openreach's estimates can be reconciled back to the audited 2007/08 regulatory financial statements. This reconciliation was set out in the Second Consultation. We explained in the Second Consultation that we were satisfied that the reconciliation identifies the key differences between the two figures. In its response to the Second Consultation, Talk Talk argued that the reconciliation

was not properly understood. We have therefore provided a more detailed reconciliation in Annex 6 and responded to Talk Talk's specific comments.

- ensured that all movements in costs during the period could be explained by simple analysis based on an understanding of future changes in demand and cost behaviour; Openreach's estimates can also be reconciled back to an earlier estimate of future revenues and costs. This reconciliation was also set out in the Second Consultation. While this reconciliation provides useful additional assurance that Openreach had adopted a logical approach to its cost modelling, Talk Talk identified this reconciliation as an additional source of concern that the methodology was not robust. We respond to Talk Talk's concerns in Annex 6.
- prepared our own estimates of future costs on a CCA FAC basis, by rolling forward audited financial data from the 2008 current cost financial statements and ensured that the outputs from Openreach's model were consistent with these estimates.

4.11 However, as explained in the Second Consultation, while the overall approach seems sensible, the reasonableness of the cost projections depends on the underlying assumptions. We explained in the Second Consultation that we did not agree with all of the assumptions proposed by Openreach and considered its cost projections were overstated as a result.

4.12 In the Second Consultation, we reviewed the key assumptions and set out ranges for these assumptions. We invited stakeholders' views to inform our final decision on the appropriate assumptions to be included in the cost projections.

4.13 As set out in detail in Annex 6 - and summarised in Table 4.2 - we have taken these views into account in forming our final position on what we consider to represent a balanced set of assumptions which, when taken together, provides a coherent basis for forecasting Openreach's costs.

Table 4.2: Summary of key assumptions

Parameter	Ofcom view in Second Consultation	Additional information since Second Consultation	Ofcom conclusion
Aggregate Volumes	Demand for fixed lines to fall by between 3.5% and 7% by 2012/13.	More recent volume data & stakeholder responses.	Demand for fixed lines to fall by 7% by 2012/13. See Annex 7.
Change in mix- internal demand for MPF	Demand for MPF lines from within BT to increase to between 9m and 11m lines by 2012/13.	BT announces suspension of plans for migration to MPF.	Internal demand for MPF lines to increase but remain below 0.5m lines. See Annex 7.
Change in mix- external demand for MPF	External demand for MPF lines to increase to between 4m and 5m lines by 2012/13.	Stakeholder responses plus Sky's announcement of intention to migrate customers to MPF.	External demand for MPF lines to increase to around 5m lines by 2012/13. See Annex 7.
Change in mix - other	Demand for SMPF to fall to between 4m and 5m lines.	Changes in investment plans announced by BT and Sky.	Total demand for SMPF to fall to around 11m lines by 2012/13. See Annex 7.
Inflation	Annual inflation to be 3% from 2008/09.	Annual inflation has fallen and recent projections indicate low inflation in the short term.	Annual inflation to be 0% between 2008/09 and 2009/10 then 2.5% thereafter. Specific adjustments to costs – such as reduced cumulo rates – should

			also be taken into account. See Annex 6.
Pay costs	Real wage inflation was modelled at RPI+1%, although RPI+0.5% defined the low end of the range for long term increases in pay costs.	BT has announced pay freeze in 2009/10. General rate of inflation has fallen with potential implications for rate of real wage inflation.	Long term average real wage inflation of 1% pa. See Annex 6.
Pension costs –deficit	Regulated charges should not include any contribution to the funding of the pension deficit.	Openreach provided a consultant's report to support its case that our approach appears to be at odds with other regulators' conclusions. Other stakeholders argued that they are not forward looking costs and should be excluded. We have reviewed evidence of how these costs have been treated in previous regulatory decisions.	Regulated charges will not include any contribution to the funding of the pension deficit. However, our long term approach to the funding of pension deficits should be considered in a separate consultation. See Annex 6.
Pension costs – future costs	Annual charges to meet future liabilities should be included in our assessment of recoverable costs.	BT has announced plans to reduce future liabilities by changing terms of pension scheme.	Annual charges to meet future liabilities should be included in our assessment of recoverable costs and recent cost-reduction plans should be taken into account. See Annex 6.
Energy costs	No adjustment proposed but we will revisit the long term assumption in our final assessment.	Energy costs have fallen since the costs set out in the Second Consultation were calculated. Openreach has explained that much of its energy spend in 2009/10 will be based on forward looking contracts negotiated at higher prices.	Recent reductions in energy costs must be taken into account, but we accept that actual costs based on forward looking contracts effected prior to 2009/10 should be recovered. See Annex 6.
Commodity prices	Under a CCA approach to setting prices, assets are valued by reference to the cost of replacing the asset at today's prices.	Copper prices have fallen since the costs set out in the Second Consultation were calculated.	Assets are valued by reference to the cost of replacing the asset at today's prices. Recent reductions in copper prices must be taken into account. See Annex 6
Scope for efficiency gains	Annual efficiency gains of between 2% and 4% (excluding fault rates) on compressible costs.	Several stakeholders have offered views on the appropriate level for efficiency targets. We have obtained and reviewed Openreach's latest operational plans to establish their expectations for efficiency gains.	Efficiency gains of 4% in 2009/10 (excluding fault rates) on compressible costs and declining thereafter. See Annex 9.
Reduction in fault rates	Fault rates to fall by between 4% and 6% each year.	Several stakeholders have offered views on the appropriate level for efficiency targets.	Fault rates to fall by 2% each year. See Annex 9.
Cost allocation	Some reallocation of costs – of between £49m and £98m –away from the Core Rental Services to unregulated services may be appropriate.	Openreach has accepted that some reallocation of costs – at the low end of our estimate - may be appropriate. Other stakeholders have proposed even greater reallocation.	Costs of £88m should be reallocated away from the Core Rental Services. See Annex 6.

A new pricing framework for Openreach

Group Costs	Other than the specific exceptions noted elsewhere, no adjustment to Group costs is proposed.	Openreach agreed with our proposal. Other stakeholders generally did not.	Other than the specific exceptions noted elsewhere, no adjustment to Group costs is necessary. See Annex 6.
IS costs	Some IS costs might be excluded.	Respondents have provided views on the appropriate treatment of IS costs.	No adjustment to Openreach's estimate of IS costs. See Annex 6.
Line cards⁷	Openreach's estimate of costs per line appears reasonable.	Respondents have provided views on the appropriate treatment of line card costs.	Openreach's estimate of costs per line appears reasonable. See Annex 6.
SLG payments	Openreach should recover efficiently incurred costs. Our estimate is lower than Openreach's.	Openreach has provided reduced estimates of efficiently incurred costs.	Openreach should recover efficiently incurred costs. Openreach's adjusted cost estimates look reasonable. See Annex 6.
Light User Scheme	The cost of the LUS should not be recovered through the regulated services, with the possible exception of the administration costs.	In its response, Openreach acknowledged that Ofcom has disallowed the recovery of LUS from the regulatory cost stacks presented in BT's 2007/08 regulatory financial statements, and, to be consistent with the RFS, excluded the costs of LUS.	None of the cost of the LUS should be recovered through the regulated services, including administration costs. See Annex 6.
Regulatory Asset Value ("RAV")	Openreach's assessment of the RAV adjustment appears reasonable.	Respondents have provided views on the basis for the RAV adjustment	Openreach's assessment of the RAV adjustment appears reasonable. See Annex 6.
Dropwire costs	To be consistent with our previous approach, a proportion of capital costs relating to residential dropwires installed between 2000/01 and 2004/05 should be excluded.	Openreach has accepted that this adjustment is appropriate.	To be consistent with our previous approach, a proportion of capital costs relating to residential dropwires installed between 2000/01 and 2004/05 should be excluded. See Annex 6.
Line length adjustment	Openreach's approach provides a reasonable basis for determining the line length adjustment. No further adjustment is proposed.	Respondents have provided views on the basis for the line length adjustment	Openreach's approach provides a reasonable basis for determining the line length adjustment. No further adjustment is proposed. See Annex 6.

4.14 On this basis, we have projected what we consider to represent a reasonable estimate of Openreach's costs and revenues (at current prices) for the Core Rental Services, as set out in Table 4.3, below.

⁷ To be reviewed in WLR charge control project.

Table 4.3: Ofcom estimate of CCA costs and revenues for Core Rental Services, assuming prices remain fixed in nominal terms

	Core Rental Services					
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	£'m	£'m	£'m	£'m	£'m	£'m
Revenue	2,687	2,670	2,597	2,518	2,462	2,423
Pay	478	493	446	420	440	438
Line card and Tams	258	257	255	253	244	211
Accommodation	258	265	255	259	266	272
Stores, contractors, SMC and misc.	125	121	112	110	108	103
Corporate Overheads	95	98	90	83	85	84
IT (ex depn)	130	135	121	113	115	114
Fleet	84	86	78	77	76	72
Other	18	6	5	5	2	1
Operating Cost	1,446	1,462	1,361	1,319	1,335	1,295
EBITDA	1,242	1,209	1,236	1,199	1,127	1,127
Depreciation inc Holding gains	267	666	571	458	508	547
EBIT	975	543	665	742	618	580
ROCE%	14%	8%	10%	11%	9%	8%
Mean Capital Employed	7,026	6,879	6,908	7,000	7,153	7,250

- 4.15 In Annex 6, we compare this estimate to our earlier estimate of the costs and revenues across the Core Rental Services. It shows that we now estimate that the EBIT on these services will be higher than we estimated in December. This is for several reasons, including the effects of lower inflation, reduced commodity prices and lower than expected rates of migration away from WLR and SMPF, following BT's decision to suspend its plans to move to MPF.
- 4.16 As shown in Table 4.3, the estimated rate of return in 2008/09 is reduced by the effect of a holding loss of in the year (which has the effect of increasing the depreciation charge in the year). This is largely due to the fall in the value of copper assets during the year, as described in Table 4.2.
- 4.17 Now that we have established the cost base for the core rental services, in the next part of this section, we will consider the level of return we consider is appropriate which is derived from our estimate of the cost of capital for Openreach.

Cost of capital

- 4.18 In the First and Second Consultations we set out our views on the proposed approach to estimating the cost of capital for the main existing Openreach business. As we explained our previous assessment of the cost of capital estimated a weighted average cost of capital of 10% for 'BT's copper access network', which maps onto the main part of Openreach's existing operations. As set out in Annex 8, we have updated our calculations to take account of responses and additional analysis, culminating in final point estimates of the cost of capital for the BT businesses in question.
- 4.19 In the Second Consultation, we noted that international capital markets had deteriorated since the First Consultation, with a number of financial institutions failing or receiving substantial state funding, both in the UK and the rest of the world. This

process has continued, and has been accompanied by a move towards a global recession.

- 4.20 The uncertainty in the equity and credit markets observed at the time of the Second Consultation has continued. We noted previously that cost of capital inputs had changed materially between the First and Second Consultations. While inputs have not changed as much in the period since the Second Consultation, this is still a period in which great care needs to be taken in separating short-term and long-term effects.
- 4.21 As in the Second Consultation, we also look at the impact of using current spot rates to determine the cost of capital for BT and Openreach. As we note below, these estimates are purely illustrative, as we are not confident that current market rates provide a reliable indicator of composite capital costs over the next few years.
- 4.22 In the First Consultation, we proposed an estimated range for Openreach's pre-tax nominal WACC of 9 – 10% (versus the 2005 figure of 10.0%), and 10 – 11% for the rest of BT (versus the 2005 figure of 11.4%). These ranges were consistent with a BT Group range of 9.5 – 10.5%.
- 4.23 In the Second Consultation we took account of changes to the parameters of the WACC estimates and re-calculated our range of estimates for Openreach's pre-tax nominal WACC to 9.25 – 10.75%. Our proposed range for the pre-tax nominal WACC for the rest of BT was 10.25 – 11.75%. These ranges were consistent with a BT Group range of 9.75 – 11.25%.
- 4.24 In the Statement we have taken account of all responses, and changes to the parameters of the cost of capital in order to arrive at a final point value of 10.1% for Openreach's pre-tax nominal WACC. Our final value for the rest of BT is 11.0%. These are consistent with a BT Group WACC of 10.6%.
- 4.25 Our calculations are based on the following range of estimates.

Table 4.4: Openreach, BT Group and Rest of BT Cost of Capital

	Openreach	BT Group	Rest of BT
Equity Risk Premium	5%	5%	5%
Equity Beta	0.76	0.86	0.96
Risk-free rate ⁸	4.5%	4.5%	4.5%
Debt premium	3%	3%	3%
Pre-tax nominal WACC	10.1%	10.6%	11.0%

- 4.26 In the Second Consultation, we assumed a 3% rate of inflation. As set out in Table 4.2, in light of recent information we are now assuming an annual rate of inflation of zero between 2008/09 and 2009/10 and 2.5% thereafter. A cost of capital of 10.1% at a time of 2.5% inflation is therefore equivalent to a cost of capital towards the high end of our 9.25-10.75% range. For the purposes of calculating the allowable return in 2009/10 – at a time of zero inflation – we have reduced the nominal cost of capital by 2.5%.

⁸ The nominal risk-free rate given here is for years 2 – 4 of the charge control, when we assume inflation of 2.5% p.a. Note that in year 1, our inflation assumption is 0%, which would be associated with a nominal risk-free rate of 2.0%, and a pre-tax nominal WACC of 7.6% for Openreach.

- 4.27 In arriving at these values, we have considered the need to ensure an appropriate environment for the development of competition to deliver optimal consumer outcomes. In this context, amongst other things we considered our duty to promote efficient investment, and as such should set rates of return at a level that allows a reasonable return on investment and encourages future efficient investment.
- 4.28 We would note that these rates of return do not apply in the case of Next Generation Access investment (see Ofcom's recent paper entitled "Delivering super-fast broadband in the UK"⁹).

Calculation of Unit costs

- 4.29 The cost and revenue projections for the Core Rental Services – as summarised at an aggregate level in Table 4.3 – are set out in Annex 6 and summarised for MPF and SMPF below, together with the estimate of the unit cost for each of those services, including a 7.6% rate of return in 2009/10 and 10.1% thereafter.

Table 4.5: CCA costs and revenues for MPF rentals, assuming prices remain fixed in nominal terms

	MPF Line rental					
	2007/08 £'m	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	101	159	206	251	355	446
Pay	25	36	46	54	81	101
Line card and Tams	0	0	0	0	0	0
Accommodation	13	19	26	32	48	62
Stores, contractors, Service centre etc	6	9	12	14	20	24
Corporate Overheads	5	7	9	11	16	19
IT (ex depn)	7	10	12	14	21	26
Fleet	4	6	8	10	14	17
Other	-1	-3	-3	-4	-6	-7
Operating Cost	58	84	109	130	193	242
EBITDA	42	75	97	120	163	204
Depreciation inc Holding gains	13	47	57	56	89	120
EBIT	30	28	40	64	74	84
ROCE%	8%	6%	6%	7%	6%	5%
Mean Capital Employed	352	498	711	899	1,321	1,692
Volumes	1,260	1,821	2,521	3,067	4,346	5,461

Table 4.6: Unit cost of MPF rental

	MPF Line rental					
	2007/08 £	2008/09 £	2009/10 £	2010/11 £	2011/12 £	2012/13 £
Operating unit cost	56.31	71.84	65.78	60.82	64.72	66.33
ROCE unit cost	28.23	27.64	21.42	29.59	30.69	31.29
Total unit cost	84.53	99.48	87.20	90.41	95.42	97.62

⁹ http://www.ofcom.org.uk/consult/condocs/nga_future_broadband/statement/

- 4.30 The increase in unit costs in 2008/09 is largely due to the holding loss on copper assets in the year (as described above). The subsequent reduction in unit costs in 2009/10 reflects the absence of a similar holding loss on the copper assets in that year and the net effect of the reduced inflation assumption, which reduces the holding gain on the other assets below the 2008/09 level (which causes unit costs to rise) but also reduces the nominal rate of return to 7.6% (which reduces unit costs by a greater amount).

Table 4.7: CCA costs and revenues for SMPF rentals, assuming prices remain fixed in nominal terms

	SMPF Line rental - Ext & Int					
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	£'m	£'m	£'m	£'m	£'m	£'m
Revenue	167	183	182	185	177	171
Pay	50	53	50	50	49	48
Line card and Tams	0	0	0	0	0	0
Accommodation	34	36	39	40	39	39
Stores, contractors, Service centre etc	9	9	9	9	8	8
Corporate Overheads	9	10	9	9	9	9
IT (ex depn)	14	15	14	14	13	13
Fleet	4	5	4	4	4	4
Other	1	0	0	0	0	0
Operating Cost	121	127	125	126	123	120
EBITDA	46	55	57	59	53	51
Depreciation inc Holding gains	19	19	22	25	30	33
EBIT	27	37	35	35	23	17
ROCE%	36%	44%	37%	31%	19%	13%
Mean Capital Employed	75	83	94	110	124	130
Volumes	10,661	11,645	11,661	11,886	11,330	10,930

Table 4.8: Unit cost of SMPF rental

	SMPF Line rental - Ext & Int						
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2008-13
	£	£	£	£	£	£	CAGR
Operating unit cost	13.10	12.52	12.57	12.69	13.53	14.02	12.0%
ROCE unit cost	0.71	0.72	0.62	0.94	1.11	1.20	65.8%
Total unit cost	13.81	13.24	13.18	13.63	14.64	15.22	14.9%

- 4.31 In Annex 6, we have set out the basis for these calculations in more detail. For information we also include a current assess of costs for the WLR rental services, although these are subject to further review prior to the forthcoming WLR

consultation, in the light of decisions on BT's 21CN programme and market review implications.

Conclusion

- 4.32 The financial evidence summarised in this Section supports a general case for increases in the charges for MPF rentals. The current SMPF prices appear likely to exceed the cost of provision in the short term.
- 4.33 As explained in Section 2, we will not set revised prices for WLR at this stage. However, the financial evidence in this Section will be taken into account if the ongoing market review concludes that price controls on WLR continue appropriate.
- 4.34 Section 5 sets out the other factors we have taken into account in determining how prices should change. Specifically, it explains why we have placed considerable weight on evidence based on fully allocated costs as part of our review to determine the appropriate pricing regime for the MPF and SMPF services.

Section 5

Implications for prices

- 5.1 In Section 4, we set out our assessment of the fully allocated current cost (“CCA FAC”) of providing the Core Rental Services. In this Section, we explain why we have placed considerable weight on this cost evidence in deciding how to modify the price control for MPF. We also set out the other factors that we have taken into account when determining how prices should be modified.
- 5.2 We explain that:
- we have placed significant weight on CCA FAC in determining the appropriate charges for the Core Rental Services;
 - we have also considered the potential impact of price changes on, for example, competition and consumers;
 - in assessing cost and charge levels, we have also taken account of other sources of evidence, including international price benchmarking;
 - we consider there is a strong case for using a glide path to phase in changes to charges; and
 - we also consider there is a case for a price path that involves a larger increase in the MPF charge in the first year.
- 5.3 In Section 2, we said that the analysis presented in the Sections and Annexes of this Statement represents an impact assessment. The analysis in this Section, and that of the supporting Annexes 4 and 5, form a key part of that impact assessment.

Cost standard used to set charges

- 5.4 In the Second Consultation, as in this Statement, our projected cost stacks were prepared on a CCA FAC basis. We said in the Second Consultation that the use of CCA FAC offers some important practical advantages, including:
- it is a widely understood concept and has been the anchor point for many previous price controls; and
 - it uses data that can be reconciled to the regulatory financial statements, which are audited and, generally, in the public domain.
- 5.5 We also considered whether we should move away from CCA FAC for efficiency reasons. Our preliminary conclusion was that there were not strong efficiency reasons for moving away from CCA FAC.
- 5.6 In responses to the Second Consultation, there was some support for CCA FAC as an appropriate cost standard. However, other responses disagreed with the use of CCA FAC, and argued that other ways of setting charges would be more efficient and more in consumers’ interests.
- 5.7 We have carefully considered the responses. We accept that in general setting charges primarily with regard to CCA FAC may not necessarily lead to the most

efficient outcome. But in this Statement, as in the consultation, we have explicitly considered whether there are strong objections to CCA FAC on efficiency grounds for the particular charges we are setting. We set out this analysis in Annex 4. We consider one important efficiency issue relates to the potential for distortions to competition. In particular, if the differential between MPF and WLR+SMPF is not cost based, it may result in an inefficient mix of wholesale products being used. Because of this, we consider that the differential needs to reflect costs rather than demand based factors (such as Ramsey pricing). For the reasons set out in Annex 4, we consider CCA FAC results in an appropriate cost based differential.

- 5.8 As described in Annex 4, we conclude that setting charges equal to CCA FAC is broadly consistent with achieving an efficient outcome in this case. We therefore consider it to be in consumers' interests.

Price path

- 5.9 In light of our view in the Second Consultation that CCA FAC was an appropriate cost standard, we considered various approaches to modifying prices to close the gap between existing charges and that cost standard. We considered that setting charges by means of a glide path so that charges were in line with the cost standard after four years would be most in consumers' interests. In general, we favour glide paths because they smooth changes and avoid any dislocation in the market and because they place stronger cost efficiency incentives on regulated companies. Moreover, we considered that by employing a methodology consistent with our previous practice, our approach would give investors confidence in the predictability of the regulatory regime in the future.
- 5.10 We said that in the simplest form of glide path, prices would increase at a constant real annual rate. However, in theory, the rate of change could change each year and a glide path does not necessarily rule out, for example, a relatively higher or lower increases in the opening year of any control.
- 5.11 Some responses were in favour of a smooth glide path. Other responses favoured either more gradual changes in charges or an immediate move to the cost standard. In Annex 5, we set out in details the responses and our views on them.
- 5.12 For the reasons set out in Annex 5, we remain of the view that there is a strong case for a four year glide path approach is appropriate. We also explain in Annex 5 that we also consider there is a case for a price path that involves a larger increase in the MPF charge in the first year. We consider this appropriate because it reduces the potential distortion to the choice between MPF and WLR+SMPF.

Impact on consumers

- 5.13 In the Second Consultation, we said we did not consider that our proposals would lead to a significant increase in consumers' total bills while some respondents stated that some increase in total bills was possible. We considered that raising the wholesale charges would be in consumers' interests even if retail prices were ultimately to rise somewhat as a result.
- 5.14 Talk Talk argued that it would be inappropriate for Ofcom to allow an increase in wholesale charges. This was because Openreach was already earning returns in excess of its cost of capital for the core rentals services as a whole, and was forecast to continue to do so for 2009/10 and 2010/11.

- 5.15 Even though retail prices may be somewhat higher than they would otherwise be as a result of the changes we are making, we nevertheless consider that this is in consumers' interests. In the extreme, if the increase in MPF rental charges were passed through in full to consumers supplied using MPF, it would result in an increase in charges of around 45p per month in 2009/10 (including VAT) and around 80p per month in 2010/11. As we explain in more detail in Annex 5, we consider this is in consumers' interests for the following reasons:
- Raising the MPF charge reduces a distortion to competition that is ultimately likely to result in a more efficient outcome.
 - At some point, Openreach will need to increase its charges to recover its total costs, or else it will cease to have an incentive to invest and maintain the network. We consider that increasing charges gradually helps to ensure a stable and predictable regulatory regime. This should allow all CPs to make informed, confident investment decisions.
 - Phasing in changes in charges also sends a signal that we will adopt a gradual approach in the future and should lead to stronger cost minimisation incentives on Openreach, which should tend to mean lower charges in the long run.
- 5.16 Talk Talk also suggested in its response that our proposals would result in a reduction in up to 1 million fewer households subscribing to broadband services by 2012/13. For the reasons set out in Annex 5, we do not believe that our decision will have a significant impact on the current trend in broadband penetration.

Impact on CPs using MPF

- 5.17 We recognised in the Second Consultation that our proposals potentially had implications for the value of the investments of CPs using, or planning to use, MPF.
- 5.18 The size of the impact on an LLU operator's profitability will depend on the particular characteristics of the operator. In Annex 4 we have set out what respondents said about the impact on MPF users, and also our calculations on the possible size of the impact. For large users of MPF, such as Talk Talk, we consider that the impact of our decision is most likely to reduce the internal rate of return on LLU investment by between 2 and 6 percentage points, compared to assuming constant nominal charges.
- 5.19 This impact on LLU operators is a concern, and has been an input to our consideration of the appropriate price path. But our intention is not to guarantee the returns of LLU operators. Rather, we aim to provide a stable and predictable regulatory framework that allows operators to make informed and efficient judgements about future investments.

Dealing with uncertainty

- 5.20 In the First Consultation, we noted that the FAC costs estimates are highly dependent on the assumptions on volume and mix of services, which must be considered to be particularly subject to variation in the current economic climate.
- 5.21 We noted that substantial variation from the expected volumes (both internal and external) will influence the long term direction of pricing and would be a factor when we come to re-assessing the price controls direction after two years.

- 5.22 Stakeholder responses supported our caution, noting the high potential volatility. However, as Openreach noted, while the economic climate may influence the outcome of the review, it does not prevent the development of an effective regulatory framework. Stakeholders also noted that Ofcom's determination of the new framework will be critical to the creation of appropriate economic investment incentives.
- 5.23 Tiscali did suggest that we should consider a mid-point review of the controls should we identify major movement away from our assumptions.
- 5.24 We accept there is a forecast risk, but given the relatively short duration of the price controls and the advantages noted by Openreach with respect to regulatory certainty we propose that, barring unforeseeable dramatic changes in circumstance, we would not plan on a review of the controls until near the completion of the proposed period.

Section 6

Ancillary services

Introduction

- 6.1 The scope of our review has been explained in Section 2. To recap, our review has considered the cost of providing the Core Rental Services and all Ancillary Services, together with the allocation of costs across all services including Non-Regulated Services. The main focus of this Statement so far has been on the Core Rental Services.
- 6.2 In this Section, we conclude on the appropriate treatment of the Ancillary Services, which are essentially services that relate to the Core Rental Services that are of an ancillary nature but which also fall within markets in which BT has been found to have SMP. Our conclusions include the appropriate scope and design of the baskets and the estimated cost of delivering the services in each basket, after having carefully considered the consultation responses. This Section provides a summary of the proposals, stakeholders' responses and our final analysis and position which are set out in detail in Annex 10.
- 6.3 As explained below, we have decided to introduce baskets that are similar in design to those proposed in the Second Consultation, with a few minor amendments made in light of stakeholder responses.
- 6.4 The baskets which we have decided to use are:
- MPF ancillary services: This contains the key services of new MPF provisions and migrations and all other MPF only support services considered essential for the provision of the core service (a full table of services is set out in Annex 1)
 - SMPF ancillary services: As above this contains the key services of new SMPF provisions and migrations and all other SMPF only support services considered essential for the provision of the core service (a full table of services is set out in Annex 1)
 - Co-mingling service: This includes all essential support services which are used jointly by SMPF and MPF, including the co-location services (a full table of services is set out in Annex 1)
- 6.5 The baskets exclude services which are either optional (ie enhanced care or expedited installation) or bespoke priced. Such services may, however, be subject to cost-orientation.
- 6.6 As proposed in the Second Consultation, we have decided to institute an inertia clause of 10% which limits the relative movement of charges in a given basket. We are also applying sub-caps to key migration services.
- 6.7 With respect to the MPF new provide, MPF transfer and SMPF connection charge, we have identified that they are substantially out of alignment with cost and require both immediate adjustment (down from £99.95 to £76 for MPF new provide and upward from £34.86 to £38 for MPF transfer and SMPF connection) plus a modified sub-cap.

Proposed baskets

Our proposals

- 6.8 Although the Core Rental Services include both WLR and LLU services, we proposed in the Second Consultation only to impose new charge controls for the LLU services in light of the no material change assessment we set out in Annex 6 to that document. The grouping of services into baskets was (and remain) therefore only relevant to charge controlled LLU services. For WLR, we proposed to simply update the charge ceilings lasting until the relevant services market in which WLR falls had been fully reviewed. As explained in Section 2, we are no longer proposing to impose immediate changes to those ceilings. This will be addressed in a separate consultation planned for next month.
- 6.9 We proposed in the Second Consultation that the Ancillary Services should be grouped into baskets of services, built around the underlying core service, as follows:
- MPF ancillary services, including new provisions and migrations;
 - SMPF ancillary services, including new provisions and migrations; and
 - Co-mingling services, including services related to the provision of space at BT premises.
- 6.10 We also proposed some basic principles to be adopted when designing these baskets, namely the regulation imposing the charge controls should:
- be easy to understand and straightforward to implement;
 - contribute to efficiency in service provision;
 - ensure that the controls cannot be manipulated by Openreach in a way that puts other CPs at a disadvantage.
- 6.11 Having considered the responses to the First Consultation, we considered that a basket approach had a number of advantages, including:
- **flexibility:** baskets allow flexibility so that individual charges can reflect cost and demand changes;
 - **efficient recovery of common costs:** baskets provide incentives to recover common costs efficiently;
 - **practicality:** baskets are practical given the large number of charges, thus reducing the administrative costs of setting charges; we noted, in particular, that it would be a very major exercise to set individual controls for over a large number of services (in excess of one hundred in this case) with any confidence that each charge would be set at an appropriate level.
- 6.12 We recognised, however, concerns raised by those responses that dangers existed with allowing baskets that are too wide, especially the risk of BT distorting competition by structuring charges to favour its own downstream operations. For example, if there are differences in the services that BT tends to buy relative to other CPs, then Openreach may set low charges for those services BT tends to buy and high charges for services that other CPs tend to buy. In particular, as BT has an

incumbent position, it may tend to favour high switching costs ie increase charges for connecting new customers in favour of low rental costs, which would be contrary to the interests of new entrants.

Responses to the Second Consultation

- 6.13 There was a wide range of responses on the proposals for baskets both in terms of the scope of the baskets (i.e. the services to be covered) and their effectiveness (i.e. the efficient allocation of resources and the protection of service purchasers). We set out in Annex 10 the main responses received on these matters.
- 6.14 However, in summary, respondents were split between Openreach concerns over the need to an appropriate level of flexibility and simplicity and other stakeholder concerns over manipulation of the absolute and relative charges of services by Openreach potential with a potential bias toward other BT customers or overly exploiting temporary changes in demand.
- 6.15 Non-Openreach stakeholders were also concerned about the need to ensure that key migration services were predictably priced.
- 6.16 There were also concerns about control of future changes to services or introduction of new services – that is CPs did not want Openreach to be able to shift functions from a charge controlled service to one not charged controlled.
- 6.17 Finally, stakeholders noted that they did not agree with the Openreach assertions on what services were subject to cost-orientation under the SMP conditions. We have reviewed that issue specifically in Annex 10 and below.

Conclusions on basket controls for Ancillary Services

- 6.18 We set out in Annex 10 our detailed arguments for our treatment of Ancillary Services including our response to stakeholders concerns set out above. Below is a summary of the positions reached.

Design of individual and baskets controls

- 6.19 We consider that the existing proposed divisions between MPF, SMPF and co-mingling baskets remain appropriate.
- 6.20 The design reduces the opportunity for Openreach to trade off between services while still allowing them to structure relative prices efficiently.

Starting charges and sub-caps

- 6.21 We have reviewed the current individual charges proposed for inclusion in the baskets and with three exceptions consider that they are suitable for use as the starting charge.
- 6.22 Also, in the Second Consultation, we acknowledged that, as raised by some respondents to the First Consultation, that there is a particular sensitivity to the key migration charges. The charges for these services would have an impact on the cost of obtaining new customers and could act as a barrier to entry. We proposed the application of sub-caps on the charges applying to MPF transfer, MPF new provide, MPF cease, SMPF connection and SMPF cease. We considered that these sub-caps would limit the potential increases in those charges to the overall limit of the

basket. They would, however, allow Openreach the flexibility to re-balance all charges within the basket.

- 6.23 The starting charge exceptions are the starting charge for MPF New Provides, MPF transfer and SMPF Connection. Our analysis suggests that these charges are substantially out of alignment with FAC costs. In particular, we need to consider the relationship between this charge on the promotion of new LLU services compared with the WLR new provide charge (which we will shortly be considering in the WLR Charge Control consultation). The MPF charge, currently £99.95, is substantially above FAC costs (which is around £42 in 2012/13) while the MPF transfer and SMPF connection, currently £34.86, is currently below FAC (which is around £50 in 2012/13).
- 6.24 Accordingly, as set out in Section 7, we are setting revised starting charges for these three services which will act as a charge ceiling for these charges in the first year.
- 6.25 We will also set distinct sub-caps for the three charges, while with respect to the respect to the remaining sub-caps we consider that the consultation proposal remains appropriate and such caps will be applied at the level of the overall basket control.

Inertia clause

- 6.26 In the Second Consultation, we proposed the inclusion of an inertia clause¹⁰ to apply for the baskets, restricting individual relative price movement of charges. The aim was to protect Openreach's customers from radical restructuring of charges on a year by year basis. Our proposal was that the percentage controls should be between 5% and 10%.
- 6.27 We acknowledge the concerns expressed by the stakeholders on the potential for Openreach to substantially and rapidly change the charges for services to the detriment of their customer. However, we consider that it would be inappropriate to unduly restrict Openreach's decisions within the baskets. For that reason, we consider that the controlling percentage for the inertia clause should be set at the upper end of the proposed range, which is 10%. This level will allow BT to vary relative charges up to 20% in a given year which while substantial will not allow rapid year on year rebalancing of charges to reflect short term changes in demands and would ensure that Communications Providers are better able to predict the direction of changes to charges. These services also remain subject to a cost orientation obligation which will mean that Openreach is not able to set individual charges that conflict with this obligation even if such charges are valid within the basket control.

Other Openreach LLU related services

- 6.28 At Annex 7 to the Second Consultation, we published a list of LLU services for the purpose of identifying their current prices, including when and if charges were set for them. This list was based on a similar list provided by Openreach. In addition to the prices and history, the list included an initial view on whether or not the services were subject to the cost orientation requirement.
- 6.29 We have carefully reviewed the responses to our provisional statements on services subject to cost orientation as contained in that list.

¹⁰ The wording of this inertia clause was set out in paragraph FA3(A).6 of Schedule 1 to the notification published at Annex 8 to the Second Consultation.

- 6.30 We note, in particular, that Openreach argue that the distinction between services subject to cost orientation and those not subject to cost orientation is that those not subject to cost orientation are discretionary and not a direct requirement in terms of network access or LLU.
- 6.31 Other stakeholders argue that such services are an integral element in the provision of a LLU service and that, in general, they have no alternative source of supply of these services.
- 6.32 Having reviewed the responses, we now consider that the distinction Openreach drew between LLU related services that were or were not subject to cost orientation, as set out in the list of the Second Consultation, may not be accurate.
- 6.33 We have set out our reasoning in more detail in Annex 10 but in summary we conclude that it is clear that Condition FA3.1 applies to the market for wholesale local access services within the UK but not including the Hull Area and to the provision of Co-Location, in which BT has been found to have SMP. The key question is therefore whether the product or service in question falls within that market and, as such, subject to BT's requirement to provide Network Access¹¹ under either Condition FA1 or, more specifically, the specific LLU services subject to Condition FA9. We will consider this issue in more detail in the next Wholesale Local Access Market Review.
- 6.34 We do not, however, consider that this has a direct bearing on our main conclusions. Our decisions on appropriate baskets have been reached by identifying those forming part of core services and, therefore, essential to their provision.

Costs of providing services in each basket

Our proposals

- 6.35 As noted above, we proposed in the Second Consultation that the Ancillary Services should be grouped into baskets of services, built around the underlying core service, as follows:
- MPF ancillary services, including new provisions and migrations;
 - SMPF ancillary services, including new provisions and migrations; and
 - Co-mingling services, including services related to the provision of space at BT premises.
- 6.36 We explained in the Second Consultation that - as for the Core Rental Services – we considered that the regulated charges should be informed by our assessment of the efficiently incurred costs of provided these services.
- 6.37 We provided a mid case view of the costs associated with the provision of these three baskets. Based on these cost projections, we explained that there appeared to be a case for significant increases in the average price of SMPF and co-mingling services, while the prices of MPF ancillary services should fall significantly if they are to align with the underlying costs of provision.

¹¹ Pursuant to paragraph 3 of Schedule 1, *ibid*, the term 'Network Access' shall have the meaning prescribed in section 151(3) of the Act.

- 6.38 We also explained that, at this level of granularity and low levels of capital employed, small changes to cost allocation methodologies can have a significant – and, potentially, distorting - impact on the apparent profitability of the services.
- 6.39 In light of these considerations, and consistent with our aim not to cause undue disruption to the markets, we proposed setting charge controls for each of these baskets based on the following basis:
- Each basket – MPF ancillary services, SMPF ancillary services and co-mingling services – will be subject to a separate control (in the form of an RPI-X control).
 - The control to be applied to each basket will be based on the average price changes across all of these baskets necessary to allow prices to rise to meet the projected costs of providing all services across all baskets.
 - The control on each basket will be separate, but the level of permitted annual increases will be the same for each basket.
- 6.40 On this basis, we provided a mid-case estimate of the aggregate costs across the three baskets. Based on this analysis, we explained that the evidence on Openreach's costs appeared to support an average increase in the charges for each of the baskets. In December, we estimated that the appropriate rate of increase would probably be at a rate close to RPI.
- 6.41 To a significant extent, this assessment drew on the same methodology and assumptions as for the review of the costs of the Core Rental Services.
- 6.42 The analysis set out in Annex 6 – including our review of stakeholder responses - therefore relates to both the Core Rental Services and the Ancillary Services.

Responses to the Second Consultation

- 6.43 Responses to the Second Consultation related to the methodology and assumptions used in estimating costs impact on the Ancillary Services as well as the Core Rental Services. Talk Talk expressed concerns around the level of breakdown of cost and revenue information in support of the proposed controls for the service baskets. We deal with these concerns in Annex 6. As explained in Annex 6, we are satisfied that the level of disclosure during this consultation process has been adequate.

Conclusions

- 6.44 Based on the analysis set out in Annex 6, we have updated our calculation of the costs and revenues across the Ancillary baskets if prices were to remain at their current levels. Our updated calculations are as follows:

MPF ancillary services total

	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	40	47	47	71	66
Operating Cost	43	52	37	38	34
EBITDA	-3	-5	9	33	32
Depreciation	6	6	5	7	8
EBIT	-11	-13	-1	16	25
Mean Capital Employed	46	49	47	51	48

SMPF ancillary services total

	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	177	130	132	117	115
Operating Cost	208	165	162	141	130
EBITDA	-31	-35	-31	-24	-16
Depreciation	10	11	14	18	20
EBIT	-41	-46	-45	-43	-36
Mean Capital Employed	45	60	71	72	72

Comingling services total

	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	112	138	152	144	181
Operating Cost	126	177	177	155	185
EBITDA	-14	-39	-24	-11	-4
Depreciation	7	10	11	11	13
EBIT	-21	-49	-35	-22	-17
Mean Capital Employed	60	76	77	74	76

- 6.45 These forecasts for the baskets set out above differ from those set out in the Second Consultation. This is due in principally to changes in forecast volumes in light of CPs' and BT migration plans as set out in Annex 7.
- 6.46 For the reasons provided in the Second Consultation and set out above, we consider that the control on each basket should be separate, but the level of permitted annual increases will be the same for each basket, based on the average price changes across all of these baskets necessary to allow prices to rise to meet the projected costs of providing all services across all baskets.
- 6.47 On this basis, the aggregate costs and revenues across the Ancillary baskets (if prices were to remain at their current levels) would be as follows:

Total ancillary services					
	2008/09	2009/10	2010/11	2011/12	2012/13
	£'m	£'m	£'m	£'m	£'m
Revenue	329	315	331	332	362
Operating Cost	377	394	376	335	349
EBITDA	-48	-79	-46	-2	-13
Depreciation	23	27	31	37	41
EBIT	-71	-106	-76	-39	-28
Mean Capital Employed	151	184	194	196	196

- 6.48 We are then seeking to set basket controls to ensure that the weighted average returns for Openreach on these baskets allow Openreach to recover their WACC.
- 6.49 In setting these controls, we have also to allow for the proposed variation in starting charges and individual sub-caps for MPF new provide, MPF transfer and SMPF connections as set out above and in Annex 10.
- 6.50 While we originally consulted on the basis of an RPI related control for 2009/10, as we are now in a position to confirm inflation for the first year we are setting the controlling interest without reference to RPI for that year.
- 6.51 Our final determination for the controls is set out in Section 7.

Treatment of 'new' services

- 6.52 Finally, we address the issue of treatment of new services as raised by some respondents, particularly should BT create 'new' services which might partially replace services within the basket.
- 6.53 As a matter of policy, we would not wish Openreach to deliberately or inadvertently revise its service structure in such a way as to reduce the scope of services covered by the baskets and introduce these elements in a less regulated manner. In the Second Consultation, we included a proposed mechanism¹² to deal with any material changes (other than to a charge) made by BT to any product or service subject to the charge controls. We proposed that a "material change" would include the introduction of a new product or service wholly or substantially in substitution for that existing product or service. In such a case, our proposal was that the charge controls would have effect subject to such reasonable adjustment to take account of the change as Ofcom may direct to be appropriate in the circumstances. Before giving such a direction, Ofcom would consult on its proposal in accordance with the process set out in section 49 of the Act. On giving such direction, BT would be required to comply with it under Condition FA3(A).14.
- 6.54 We, therefore, believe that our proposals were sufficiently clear on how new services would be treated. We have, however, decided to modify the definition of each basket to supplement that mechanism by ensuring that the baskets remain fully transparent going forwards as to their products and/or services, should any changes be made from time to time. If so, Ofcom would, following consultation, give a direction to

¹² See paragraph FA3(A).11 of Schedule 1 to the notification published at Annex 8 to the Second Consultation.

amend the list of services covered by the basket in question as set out in Parts 1 to 3 of the Annex to Condition FA3(A) that we have decided to adopt.

- 6.55 We would nonetheless expect Openreach to retain in each basket the full functionality presently contained within the basket defined in the Annex to Condition FA3(A). In any event, we note that such 'new' services may fall within the cost orientation requirement in SMP Condition FA3, provided the matters discussed above are satisfied.
- 6.56 We would further note that the list of regulated services should not constrain Openreach from the development of new services.

Section 7

The new pricing framework

Introduction

- 7.1 This Section sets out our decision on the new price controls for the MPF and SMPF rental services and Ancillary Services. As explained in Section 2, we will not set new charges for the WLR rental and ancillary services ahead of the conclusion of the Wholesale Narrowband Market Review.
- 7.2 We conclude this Section by setting out the effect and reasons for the regulation in light of the legal tests, including our duties and policy objectives.

Background

- 7.3 In the Second Consultation, we set out proposed ranges for the new controls. They comprised two elements: the proposed price ceilings for 2009/10 and the proposed indexation of the ceiling for the MPF and SMPF services in 2010/11.
- 7.4 We explained that the final combination of 2009/10 charge and subsequent indexation in 2010/11 would be determined such that – if an equivalent annual indexation were to apply until 2012/13 - it would deliver a price that equals our final assessment of the projected efficient fully allocated cost of each service in the final year.
- 7.5 For the purposes of illustration, we calculated the proposed indexation ranges for 2010/11 indexation assuming that these would start from the mid-point of the respective range for the proposed 2009/10 charges. The illustrative indexation ranges were estimated such that – if applied to this mid-point starting charge – they would allow prices to approach fully allocated costs by 2012/13. The proposals were as set out in Table 7.1

Table 7.1: Year 1 charge proposed in Second Consultation

Service	Current price cap	Proposed price from 1 April 2009	Proposed indexation on 1 April 2010
MPF rental	£81.69	£85.00 to £91.00	RPI + 0.0% to RPI + 5.0%
SMPF rental	£15.60	£15.60 to £16.20	RPI - 2.5% to RPI + 1.5%

- 7.6 We proposed that the Ancillary Services should be grouped into baskets of services built around the underlying core services (MPF, SMPF and Co-mingling). We explained in the Second Consultation that the evidence on Openreach's costs supports an average increase in the charges for these baskets at a rate close to RPI.
- 7.7 Based on the analysis set out in this Statement, this Section sets out our decision on the appropriate controls for these services for 2009/10 and 2010/11.

The new pricing framework

7.8 The new controls for MPF and SMPF will be as set out in Table 7.3.

Table 7.3: New controls for MPF and SMPF

Service	Charge ceiling to apply from 22 May 2009	Indexation to apply from 1 April 2010
MPF	£86.40	RPI + 5.5%
SMPF	£15.60	RPI + 1.0%

7.9 As explained below, these new controls will apply from 22 May 2009 to a 28 day notification period for MPF.

7.10 The new controls for the ancillary service baskets will be as set out in Table 7.4:

Table 7.4: New controls for Ancillary Services

Service	Indexation in 2009/10	Indexation on 1 April 2010
MPF ancillary services	3.0%	RPI +4.5%
SMPF ancillary services	3.0%	RPI +4.5%
Co-mingling services	3.0%	RPI +4.5%

7.11 As explained below, these new controls will apply from 22 May 2009 but the implementation of any new individual charge will require 90 days notification (including the revised charges for MPF new provide, MPF transfer and SMPF connection).

7.12 These controls will apply until 31 March 2011, a period of just under 2 years.

7.13 As explained in the Second Consultation, we will soon start a market review for Wholesale Local Access which we expect to complete in 2010. As explained in the Second Consultation, ahead of this market review we proposed adjustments to the relevant charges over the next two years by reference to the evidence and analysis of the changes we anticipate over a 4 year period. As explained in the Second Consultation, we consider that the four year period allows us to take a medium term view of the impact of changes in costs, volume and efficiency levels.

7.14 Informed to some extent by the ongoing uncertainties surrounding the short term macro-economic outlook and capital markets that continue to exhibit unusual levels of volatility, we continue to believe that this approach provides the appropriate basis for setting new controls.

Setting prices for MPF and SMPF

7.15 As explained below, we have set new controls for MPF and SMPF on the basis that prices should move towards the underlying FAC in 2012/13 and move by reference to a glide path.

7.16 We also set out the proposed basis for implementing these new controls.

Prices should move to the underlying FAC by 2012/13

7.17 We explain in Section 5 why we consider it appropriate that prices should move to the underlying FAC of providing the service.

7.18 As set out in Section 4, we have estimated the efficiently incurred costs of providing each of the Core Rental Services. As explained in more detail in Section 4, our estimate of the unit costs in each year to 2012/13, are as set out in Table 7.5.

Table 7.5: Unit cost estimates for MPF and SMPF

Year	2009/10	2010/11	2011/12	2012/13
MPF	£87.20	£90.41	£95.42	£97.62
SMPF	£13.18	£13.63	£14.64	£15.22

7.19 These estimates take account of the various assumptions – included our estimates of the inflationary pressure on Openreach’s costs – as set out in Section 4.

Prices should be set by reference to a glide path

7.20 As set out in Annex 5, we consider that there is a strong case for setting charges in 2009/10 and 2010/11 by reference to a glide path. In general, we consider that glide paths offer stability and predictability and give stronger cost efficiency incentives. Using a glide path for the MPF charge would also be consistent with our usual practice, and therefore give all parties confidence in the predictability of the regulatory regime.

7.21 We explained in the First Consultation that there are advantages to price controls that take account of anticipated movements in the costs of providing the underlying services. The use of an inflation index within a control provides some protection - to both the supplier and the buyer of the services – against changes in the underlying rate of inflation, which, over time, could cause prices – in real terms - to diverge from their intended level.

7.22 Traditionally, we have linked the control to RPI (in the form of an “RPI- X” adjustment), applied to a starting charge over a number of years. RPI has been used because it is a published - and widely understood - measure of inflation.

7.23 To provide the desired protection against changes in the underlying rate of inflation, the RPI data needs to provide a relevant measure of the cost pressures facing the supplier during the period in which the price control is to apply.

7.24 For obvious practical reasons, the RPI data used in such price controls is historical, published data. As set out in the Second Consultation, for the purposes of applying the indexation in the 2010/11 controls, we are using October 2009 RPI data and drafted the Condition accordingly.

7.25 Although there are limitations to the relevance of RPI data as a measure of the input cost pressure facing BT or Openreach it has generally provided a reasonable basis on which to consider movements in costs. To the extent that it might lead to an

inconsistent or distorted measure of inflation in a particular year, the impact of these distortions might be expected to even out over a long control period.

- 7.26 However, for shorter control periods, any distortion or lag in the RPI data used in setting prices could have implications for the charges set in that year. In this case, we are setting an indexed charge for only one year. It is therefore necessary to consider whether the October 2009 RPI data provides a reasonable basis for the 2010/11 control.
- 7.27 We do not consider that the October 2009 RPI statistic is likely to provide a relevant measure of the cost pressures facing Openreach during 2010/11. There are two reasons for this, as follows:
- *The statistic is distorted.*
The cost movements taken into account to determine RPI do not currently provide an appropriate proxy for short term movements in Openreach's costs. Specifically, the current RPI inflation statistic is depressed by two factors which do not have any direct impact on Openreach's costs: the significant recent falls in mortgage interest and the VAT reduction in December 2008. Openreach's input cost inflation in 2010/11 will therefore be higher than the RPI inflation reported in October 2009.
 - *The statistic refers to the wrong time period – introducing material error.*
The current volatility of the RPI statistics means that - even if the measure of RPI provided a measure of inflation that was broadly comparable with the increase in Openreach's costs at the time it was taken - it would not be comparable with the increase in Openreach's costs over the period for which the control is to apply. Notwithstanding the distortions described above, underlying inflation is likely to increase between 2009 and 2010.
- 7.28 The impact of ignoring these inconsistencies can be illustrated by considering how a glide path based on published RPI data might look for MPF. The RPI inflation statistic for October 2008 was +4.2%. As explained below, in October 2009, it could be around -1.5%. An price control linked that added a constant X to both RPI statistics would therefore result in a large increase in 2009/10 followed by a small increase – or even a reduction- in prices in 2010/11. This approach would therefore result in an erratic glide path that had more to do with the timing and basis of the RPI statistic than movements in Openreach's underlying costs.
- 7.29 Therefore, for the purpose of this control we do not consider that this represents an appropriate mechanism for determining prices. To set a control that better reflects movements in Openreach's costs, it is therefore necessary to make an adjustment in 2010/11 to allow for the expected bias in the October 2009 RPI data.
- 7.30 When determining the relevant control, it is not possible to adjust the published RPI statistic to reflect the fact that it does not reflect movements in Openreach's costs. It is therefore necessary to adjust the X.

Implications for MPF prices

- 7.31 As explained below, we have determined the appropriate glide path for MPF in four stages.

- 7.31.1 First we considered what a four-year (real terms) glide path would look like based on our estimate of the 2012/13 costs and the expected rate of RPI inflation over the period.
- 7.31.2 Informed by that glide path, we then determined the appropriate starting charge for MPF in 2009/10 giving weight to alternative methods for determining the start charge - including the case for full cost recovery in 2009/10, as set out in Annex 5. We adopt a value close to the middle of the range bounded by these alternative approaches.
- 7.31.3 Having established the appropriate starting charge for MPF in 2009/10, we determined the appropriate glide path over the remaining three years, again based on our estimate of the 2012/13 costs and the expected rate of RPI inflation over the remaining period.
- 7.31.4 We then defined the X in 2010/11 to reflect the fact that the RPI statistic that will be used in the control does not reflect our assessment of the relevant underlying rate of inflation for the period in question.
- 7.32 Our analysis suggests that a 'true' real terms increase of approximately 1.5% per annum is needed to allow prices to move towards full cost recovery by 2012/13.
- 7.33 However, in order to deliver this real terms increase in 2010/11 we have adjusted the X to allow for the expected difference between the reported RPI in October 2009 and the actual RPI for 2010/11.
- 7.34 The difference is significant – approximately 4%. On this basis, we consider that an X of 5.5% is appropriate for 2010/11.
- 7.35 In effect this means that, if inflation is in line with our expectations, the MPF price will increase by around 4%, from £86.40 to around £90.00.

Implications for SMPF prices

- 7.36 We have followed a similar approach to setting SMPF prices. However, unlike in the case of MPF prices, we do not consider it necessary to adjust the 2009/10 charges implied by a four year glide path in 2009/10 to align them more closely to cost because the absolute difference between the current level of SMPF charges and the our estimate of the 2012/13 cost is small.
- 7.37 Based on our assessment of the underlying rate of inflation of 2.5% for Openreach's costs, we estimate that the current SMPF price would need to increase at a rate of around RPI + 2%.
- 7.38 Our analysis suggests that a real terms decrease of approximately 3% per annum is needed to allow prices to move towards full cost recovery by 2012/13.
- 7.39 As for the MPF charge, we have adjusted the X to allow for the expected difference between the reported RPI in October 2009 and the actual RPI for 2010/11.
- 7.40 On this basis, we consider that an X of 1.0% is appropriate.

Implementation of new controls

- 7.41 In the consultation document we proposed a start date for the new controls of 1 April 2009 with a one week notice requirement for BT. We believe that this was justifiable as other Communications Providers were aware of the proposed changes to charges, the ranges provided would allow them to plan their approach to those changes.
- 7.42 Openreach supported our proposals, and argued that any charges should apply from 1 April regardless of the date of the final statement.
- 7.43 Communications Providers, however, were concerned that a one week implementation was insufficient. The Talk Talk Group, Orange, Tiscali and Cable and Wireless all argued:
- that the ranges were too large to allow a precise conclusion as to how they should react to the changes – pass on or absorb; and
 - that they needed a minimum period to pass on any charges (potentially up to 90 days for third party customers).
- 7.44 The Communications Providers that the 90 day period for modification of existing charges should continue to be used.
- 7.45 We have considered the responses. We consider that the Communication Providers arguments have particular merit with respect to charges within the baskets. In these cases the baskets controls structure does not allow a Communications Provider to accurately predict an individual charge and this uncertainty has been increased by consulting on a range. Accordingly, we require Openreach to give 90 days notice for any price change of services within the basket.
- 7.46 As the SMPF rental charge is not being changed in the first year we see no reason to vary the notification period with respect to this charge.
- 7.47 As discussed in the tests below, with respect to the MPF rental we consider that the range was not so wide as to preclude Communications Providers identify they approach to an increase in charge within that range.
- 7.48 However, we accept that should Communication Providers wish to adjust their prices in response to the new charge that there is a minimum notification period required for their customers. We note that the industry is able to manage such changes within a 28 day period for other services, eg ISDN30 and new MPF charges and, therefore, such a period should be manageable. We also note that the majority of MPF customers deal directly with the purchasing CP which further reduces delays in passing on costs. Accordingly we will require Openreach to give 28 days notice of the price increase for MPF for the first year.

Setting prices for the Ancillary Services

- 7.49 In Section 6, we concluded on the appropriate treatment of the Ancillary Services
- 7.50 As explained in Section 6, we have decided to introduce baskets that are similar in design to those proposed in the Second Consultation, with a few minor amendments made in light of stakeholder responses.

- 7.51 As proposed in the Second Consultation, we have set charge controls for each basket on the following basis:
- Each basket – MPF ancillary services, SMPF ancillary services and co-mingling services – will be subject to a separate control (in the form of an RPI-X control);
 - The control to be applied to each basket will be based on the average price changes across all of these baskets necessary to allow prices to rise to meet the projected costs of providing all services across all baskets.
 - The control on each basket will be separate, but the level of permitted annual increases will be the same for each basket.
 - Price movement within the basket will be limited by an inertia clause allowing each charge to move no more than 10% above or below the overall basket percentage controls.
 - Key migration services will be subject to sub-caps. These are:
 - MPF transfer,
 - MPF new provide,
 - MPF cease,
 - SMPF connection; and
 - SMPF cease.
- 7.52 The starting charge for the services within the baskets are those set by Openreach as at 1 April 2009 with three exceptions. The exceptions are the starting charge for MPF New Provides, MPF transfer and SMPF Connection. Our analysis suggests that these charges are substantially out of alignment with FAC costs. These revised charges for MPF New Provides, MPF transfer and SMPF Connection will act as a ceiling on the charges for the first year.
- 7.53 The MPF charge, currently £99.95, is substantially above FAC costs (which is around £42 in 2012/13) while the MPF transfer and SMPF connection, currently £34.86, is currently below FAC (which is around £50 in 2012/13).
- 7.54 Accordingly we are setting the starting charges for these services at:
- for MPF new provide £76.00; and
 - for MPF and SMPF connections £38.00.
- 7.55 The changes to these charges will still require the normal notification period though in the case of the new MPF new provide charge Openreach will have to have implemented the change within 100 days of this statement.
- 7.56 Accordingly we are also proposing both distinct second year sub-caps for the three charges
- RPI-0.5% for the MPF new provide; and RPI+2.5% for the MPF transfer and SMPF connection service

- 7.57 With respect to the remaining sub-caps we consider that the consultation proposal remains appropriate and such caps will be applied at the level of the overall basket control.
- 7.58 Our approach to the determination of the basket controls is to ensure that the weighted average returns for Openreach on these baskets allow Openreach to recover their WACC.
- 7.59 In setting these controls, we have also to allow for the proposed variation in starting charges and individual sub-caps for MPF new provide, MPF transfer and SMPF connections as set out in above.
- 7.60 While we originally consulted on the basis of an RPI related control for 2009/10, as we are now in a position to confirm inflation for the first year we are setting the controlling interest without reference to RPI for that year.
- 7.61 Based on our estimate of the aggregate costs across these baskets, as set out in Section 6, and the RPI assumptions set out above, the controls on these baskets will be as follows:

Service	Indexation in 2009/10	Indexation on 1 April 2010
MPF ancillary services	3%	RPI +4.5%
SMPF ancillary services	3%	RPI +4.5%
Co-mingling services	3%	RPI +4.5%

- 7.62 These new controls will apply from 22 May but the implementation of any new individual charge will require 90 days notification including the revised charges for MPF new provide, MPF transfer and SMPF connection.

Legal tests

Introduction

- 7.63 To give regulatory effect to the decisions summarised above, we have set a new SMP condition (i.e. Condition FA3(A) – Charge control) and modified an existing SMP condition (i.e. Condition FA3 – Basis of charges). The text of those conditions are attached in Schedules 1 and 2, respectively, to the statutory notification published under sections 48(1) and 86 of the Act at Part I of Annex 3 to this Statement.
- 7.64 Linked to the setting of that condition is the withdrawal of the directions imposing charge ceilings for the annual rental for access to MPF and for the Specified LLU Services. The texts of those withdrawals are annexed at Parts II and III of Annex 3 to this Statement. We also publish a consent at Part IV of that Annex to reduce the period of prior notice BT must give to amend its charge for MPF rental. That reduced notice period only applies to the first time BT amends its MPF rental charge to take account of the new charge control. Other charges and any further amendments to the MPF rental will remain subject to the requirements under Condition FA5.

- 7.65 We are satisfied that this regulation meets our duties and the Communications Act tests and our reasoning for this view is set out below in relation to each legal instrument published in Annex 3.

Part I of Annex 3: Conditions FA3(A) and FA3

The aims and effects

- 7.66 The new Condition FA3(A) requires Openreach to ensure that its charges for the relevant Core Rental Services and Ancillary Services do not increase by more than RPI minus/plus a value of 'X' that varies according to each relevant basket and individually controlled services. The baskets and services with their respective values for 'X' are set out in the Condition. Our conclusions on basket design (including the need for an inertia clause and sub-caps on migration charges) are set out in Section 6 and on the individually controlled services in Sections 4 and 5 (including the need for charge ceilings within the cap for MPF and SMPF rentals in the first year of the control).
- 7.67 Ofcom's reasons for imposing this particular form of control and the values for 'X' are set out above. For reasons set out in this Section, the first year of the control for all charge controlled services will begin on 22 May 2009 and end on 31st March 2010, with the second year beginning on 1st April 2010 and ending on 31st March 2011. Our current policy aim is that prices should move towards the underlying FAC by 2012/13, but any continued controls from the end of the second year of the control will be considered as part of the new market review (which is expected to complete in 2010).
- 7.68 Condition FA3(A) also ensures that, where the percentage change in the first year is less (or, as the case may be, more) than the controlling percentage in question, the controlling percentage for the second year is increased by the deficient amount (or, as the case may be, is decreased by the excess amount).
- 7.69 As already discussed in Section 6 of this Statement, Condition FA3(A) also contains mechanisms to deal with, by means of directions, any material changes (other than to a charge) made by BT to any product or service subject to the charge controls, in addition to any directions we may give from time to time to amend the list of services covered by the baskets set out in Parts 1 to 3 of the Annex to Condition FA3(A).
- 7.70 Finally, Condition FA3(A) requires that BT records, maintains and supplies data to Ofcom in relation to performing the percentage change calculation. Such data is required to be provided within three months of the end of each control year. It is essential for BT to be required *ex ante* to supply this data to ensure that we can effectively monitor compliance with the controls. We expect that BT proactively adheres to the arrangements to provide data and to provide robust and appropriately sourced information for this purpose.
- 7.71 We have discussed the cost orientation requirement under Condition FA3 on BT in Section 6 of this Statement. That requirement was imposed by Ofcom in December 2004 and is unaffected by our proposals. Condition FA3(A) is therefore expressed to be without prejudice to the generality of Condition FA3. However, we have modified Condition FA3 to add clarity and certainty that BT must be able to demonstrate that also charges falling within the charge controls satisfy the LRIC+ cost orientation requirement.

7.72 There is an exception for charges for the MPF rental. That requirement will not apply to those charges for reasons similar to why the LRIC+ cost orientation requirement was excluded in relation to the MPF rental charge ceiling in 2005. Namely, for reasons discussed in this Statement, one of our assumptions taken into account in setting the charge control in Condition FA3(A) is the Regulated Asset Value (RAV) adjustment. Given that BT's pre-1 August 1997 copper access network assets account for a significant proportion of the costs that make up the MPF rental charge ceiling in the first control year (and then followed by indexation of that ceiling in the second year), the charge ceiling itself cannot be said to be 'based' on LRIC+. On the face of it, the charge ceiling is therefore not consistent with SMP Condition FA3.1, imposed on BT in December 2004, which requires BT to ensure that its charge for Network Access in the wholesale local access market are 'based' on LRIC+.

Our duties and policy objectives

7.73 We discuss our duties and objectives specific for this review in detail in Section 2 of this Statement. Our opinion of the likely impact of implementing the proposals (as discussed throughout this Statement) is that the performance of our general and specific duties under section 3 and 4 of the Act is secured or furthered by our decision to adopt the charge controls.

7.74 In particular, we consider that the charge controls will ensure that charges for wholesale services are set at a level that will enable CPs (other than BT) to compete in the provision of downstream services. Existing charge ceilings have promoted competition in this way to the clear benefit of consumers (as set out in Section 3) in respect of choice, price and quality of service and value for money. Our review confirms that such controls are necessary to sustain this level of competition.

7.75 We have had particular regard to the requirement to promote competition and to secure efficient and sustainable competition for the benefit of consumers, which are relevant to both sections 3 and 4. We have placed particular emphasis on the promotion of competition, which we consider is likely to be the most effective way of furthering citizen and consumer interests in the markets under review.

7.76 We have also borne in mind to seek the least intrusive regulatory measures to achieve our policy objectives.

7.77 In addition, we have taken into account further objectives, including:

- *Prices*: to ensure that services are available at prices that are reasonably related to the efficient costs of supply, preferably as a result of effective competition.
- *Investment and innovation*: to promote efficient investment in the development of new and innovative service.

Powers under sections 87 and 88

7.78 Section 87(1) of the Act provides that, where Ofcom has made a determination that a person (here, BT) has SMP in an identified services market (here, the wholesale local access services within the UK excluding the Hull Area), Ofcom shall set such SMP conditions authorised by that section as Ofcom considers it appropriate to apply to that dominant provider in respect of the relevant network or relevant facilities and apply those conditions to that person.

- 7.79 Section 87(9) authorises the setting of SMP services conditions to impose on the dominant provider, including:
- such price controls as Ofcom may direct in relation to matters connected with the provision of network access to the relevant network, or with the availability of the relevant facilities;
 - such rules as they may make in relation to those matters about the recovery of costs and cost orientation;
 - obligations to adjust prices in accordance with such directions given by Ofcom as they may consider appropriate¹³.
- 7.80 We rely on those powers in setting Condition FA3(A). The Access Directive to which we refer in Section 2 of this Statement confirms that the imposition of a specific obligation on an undertaking with SMP does not require additional market analysis but a justification that the obligation in question is appropriate and proportionate in relation to the nature of the problem identified. We refer in this regard to our no material change assessment under section 86 of the Act (as set out in detail at Annex 2 to show that the obligations under this Condition remain based on the competition problems already identified.
- 7.81 Linked to that matter is the requirement under section 88 of the Act in that Ofcom must not set a condition falling within section 87(9) except where it appears to us from the market analysis that there is a relevant risk of adverse effects arising from price distortion and it also appears that the setting of the condition is appropriate for the purposes of:
- promoting efficiency;
 - promoting sustainable competition; and
 - conferring the greatest possible benefits on the end-users of the public electronic communications services.
- 7.82 In setting Condition FA3(A), section 88 also requires that we must take account of the extent of the investment in the matters to which that Condition relates of BT.
- 7.83 In our opinion, Condition FA3(A) satisfies those matters, since without it there is a real risk of adverse effects arising from price distortion by BT as it might fix and maintain some or all of its prices at an excessively high level or margin squeeze. We have also set out our reasons in this Statement why we consider that existing charge ceilings are inappropriate and should no longer apply.
- 7.84 We also consider that the charge controls are appropriate for the purposes of promoting efficiency and sustainable competition and conferring the greatest possible benefits on the users of public electronic communications services. This is based, in particular, on our experience in the evolution of the market as set out in Section 3 of this Statement.

¹³ This power includes the power to impose a requirement on the person or persons to whom the condition is applied to comply with such directions with respect to the matters to which the condition relates as may be given from time to time by Ofcom or by another person specified in the condition (section 45(10)(a) of the Act).

- 7.85 In respect of efficiency, in the absence of competitive pressures, we believe that BT would have limited incentives to seek to reduce its costs of providing wholesale LLU services. But, in setting the charge controls, we are also using a RPI+X formulation so that BT is encouraged to greater efficiency in the costs of providing wholesale services by requiring it not increase its charge by more than a fixed amount each year. In coming to a view of the likely efficiency of BT's costs, we have also looked at a range of evidence including benchmarks from other markets (section 88(4)(a) of the Act) and we have had regard to the appropriate cost accounting methods (section 88(4)(b)).
- 7.86 The RPI-X also provides incentives for BT to seek further efficiency savings by allowing it to keep any returns associated with efficiency gains over and above those forecast when the charge control is set. The benefits of lower costs can then be passed onto customers.

The section 47 test

- 7.87 In addition to above-mentioned matters, Ofcom must be satisfied that Condition FA3(A) and the modification to Condition FA3 satisfy the test in section 47(2) of the Act, namely;
- objectively justifiable in relation to the networks, services or facilities to which it relates;
 - not such as to discriminate unduly against particular persons or a particular description of persons;
 - proportionate as to what the condition is intended to achieve; and
 - in relation to what it is intended to achieve, transparent.
- 7.88 We are satisfied that this test is met.
- 7.89 As regards objective justification, BT's SMP in the access markets allows it to unilaterally set charges and that, in the absence of any controls, this would have adverse impacts on both the ability of companies to compete in the downstream provision of services and on consumer choice and value for money. Our charge controls have been structured to deliver the lowest possible charges to competitors for the wholesale services, while ensuring that BT is able to recover costs, including a reasonable return on investment.
- 7.90 The structure of the controls are such that BT has an incentive to continue to seek efficiency gains and it able to benefit from efficiency achieved that are in excess of that anticipated in the review.
- 7.91 The controls are also objectively justifiable in that the benefits of RPI-X price controls are widely acknowledged as an effective mechanism to reduce prices in a situation where competition does not act to do so.
- 7.92 Secondly, the charge controls will not discriminate unduly against a particular person or particular persons because any CP (including BT itself) can access the services at the charge levels fixed. The charges are set to ensure a fair return and price level for all customer groups. In any event, Ofcom considers that they do not discriminate unduly against BT as the controls address BT's market position, including its ability and incentive to set excessive charges for services falling within the controls.

- 7.93 Thirdly, the charge controls are proportionate because BT's obligations apply to the minimum set of charges required for the delivery the bottleneck services. They are focussed on ensuring that there are reasonable prices for those access services, which are critical to the development of a competitive market. BT is, however, allowed to recover a reasonable return on investment. BT will also have incentives to continue to invest and develop its access network. Moreover, the maximum charges BT is allowed to set over the period of the control has been formulated using information on BT's costs and a consideration of how these costs will change over time.
- 7.94 As explained in Section 2 of this Statement, our review has shown that the circumstances relating to the current charge ceilings as fixed in nominal terms and unlimited in their duration are exceptional. Businesses operating in any markets are normally expected to recover all efficiently incurred costs. The financial evidence, which we have carefully analysed in detail, shows that the prevailing level of Openreach's regulated charges would not be sustainable. In our opinion, there is also a risk that maintaining that level even on a shorter term could jeopardise the attainment of our objectives. This is because there is a risk that delay in addressing the charges could lead to BT underinvesting in maintenance and service support, and would continue to encourage other CPs to invest without appropriate information with respect to the long term costs of the investment.
- 7.95 We therefore consider that the charge controls pursue our policy objectives and the means employed to achieve those aims are both necessary and the least burdensome to address effectively the concerns we have set out.
- 7.96 Finally, for reasons discussed above, we consider that the charge controls are transparent. Their aims and effect are clear and they have been drafted so as to secure maximum transparency. The texts of the Conditions themselves have also been published with this Statement. Their intended operation are also aided by our explanations in this Statement. We have also set out their likely impact on charges for the duration of the controls. As already discussed above, the aim of the modification to Condition FA3 is also to add further clarity and certainty.

Parts II and III of Annex 3: Withdrawals of the charge ceilings

- 7.97 We will deal with these Parts and their withdrawals together as they address the set of LLU services that, when taken together, are being replaced by the new charge controls discussed above.
- 7.98 For that reason alone, we consider that the aims and effects of those withdrawals are clear and self-explanatory.
- 7.99 We are further satisfied that the withdrawals meet the test in section 49(2) of the Act.
- 7.100 They are objectively justifiable in relation to the networks, services or facilities to which it relates because, in order to implement the new charge controls, we need to remove the existing controls on the LLU charges. We have also set out our views why we consider that the charge ceilings are no longer appropriate.
- 7.101 Nor do we consider that their removal discriminate unduly against particular persons or a particular description of persons.
- 7.102 They are also proportionate as it is impossible to institute the new charge controls without also removing the existing charge ceilings.

- 7.103 The withdrawals are plainly transparent upon the precondition that the new charge controls take effect. Their texts have also been published with this Statement, which clearly show which controls have been removed.

Parts IV of Annex 3: Consent for period to notify MPF rental

The aims and effect

- 7.104 The aim and effect of this Consent is clear on its face, when read together with BT's obligations under existing Condition FA5. The latter provides:

“FA5.2 Save where otherwise provided in Condition FA6, the Dominant Provider shall send to Ofcom and to every person with which it has entered into an Access Contract covered by Condition FA1 and/or Condition FA9 a written notice of any amendment to the charges, terms and conditions on which it provides Network Access or in relation to any charges, terms and conditions for new Network Access (an “Access Charge Change Notice”) not less than 90 days before any such amendment comes into effect for existing Network Access, or not less than 28 days before any such charges, terms and conditions come into effect for new Network Access provided after the date that this Condition enters into force. This obligation for prior notification will not apply where the new or amended charges or terms and conditions are directed or determined by Ofcom or are required by a notification or enforcement notification issued by Ofcom under sections 94 or 95 of the Act.”

- 7.105 In other words, BT is required under that Condition to give a prior an Access Charge Change Notice whenever it seeks to make any amendment to its charges, terms and conditions covered by Condition FA1 and/or Condition FA9. As seen, the length of notice period to be given by BT depends on whether the amendment concerns existing Network Access or new Network Access; at least 90 days' prior notice for the former and 28 days' prior notice for the latter, before the amendment comes into effect is required, must be given unless Ofcom otherwise consents in writing under Condition FA5.1.
- 7.106 The rationale¹⁴ for this obligation to provide prior notice is that it can further assist competition if CPs purchasing the wholesale services in question are given advance warning of changes. It particularly seeks to ensure that CPs have sufficient time to plan for any changes and therefore helps to ensure stability markets, including that incentives to invest are not undermined. It has, however, disadvantages such as the possibility of leading to a 'chilling' effect where other CPs follow BT's downstream prices rather than act dynamically to set competitive prices.
- 7.107 In the Second Consultation, we proposed a start date for the new controls of 1 April 2009 with a one week notice requirement for BT. We considered that this proposed reduced period of prior notice was appropriate as CPs were made aware of our proposals to change charges in the consultation (including the proposed ranges of price changes) and additionally would be given that prior notice period upon Ofcom making a decision of the new charges in its final statement. We noted, however, that the 1 April state date was based on our (then) proposed timeframe for implementation but that it was subject to our consideration of consultation responses.
- 7.108 We received four responses on our proposed Consent and our consideration of them is set out below. Section 49(9) of the Act empowers Ofcom to give effect to our

¹⁴ See paragraphs 6.109ff in Ofcom's Statement entitled “Review of the wholesale local access market”, published on 16 December 2004.

proposed Consent, with or without modifications, and we have decided to make some modifications to take account of our decision on new charges. In so doing, we believe that we are also addressing some of the respondents' concerns, who are principally calling for the standard period of 90 days to apply.

7.109 Specifically, we have decided to reduce the period of prior notice that BT must give to amend its charge for MPF rental under Condition FA5.2 from 90 days to 28 days before any amendment BT seeks to make in this regard comes into force. We believe that such charge change would concern an amendment to existing Network Access. However, we have decided that the reduced notice period should only apply to the first time BT amends its MPF rental charge to take account of the new charge control, by giving an Access Charge Change Notice in such manner and form as otherwise required by Condition FA5. Other charges and any further amendments to the MPF rental will remain subject to the requirements under Condition FA5. Our reasons for this modification are set out below.

Our views on responses to the Second Consultation

7.110 Stakeholders expressed significant concerns about the reduced notification period. In particular, Talk Talk and C&W have argued for the retention of 90 day notification for changes to existing charges. The basis for these arguments included an allowances for such factors as:

- consideration of the requirement to pass costs onto the customers;
- billing provider notification; and
- customer notification to end customers

7.111 Talk Talk also noted that our proposal was at odds with our statutory obligations. While Talk Talk accepted that there are no hard and fast rules about the timing of introducing new charges, it drew attention to Ofcom's recent waiver in relation to leased line price reductions with no prior notice to be given at all for specified prices to argue that the rationale of this prior notice obligation is to allow other players sufficient time to react to the wholesale price change, including to take any remedial action (e.g. an appeal). Talk Talk disagreed that any cogent reason existed that could justify a shorter period than 90 days as it considered the relevant test being Talk Talk having advance knowledge of the actual wholesale price, whether or not the final charge falls within the range Ofcom has proposed.

7.112 We accept that a rapid implementation of revised charges may have some organisational issues and potential revenue implications. Also we accept that there is no specific requirement for charges to be implemented from 1 April, which in any event is no longer possible.

7.113 Accordingly, we have revised the notification waivers. We are now only proposing to waive the 90 day notification for the change to MPF rental. The revised notification period will be 28 days. The control will commence from 22 May 2009.

7.114 As discussed in this Statement, we have placed particular emphasis on the promotion of competition, which we consider is likely to be the most effective way of furthering citizen and consumer interests in the markets under review, in reaching our decisions on final charges. We have, however, reached those decisions against the backdrop of the circumstances relating to the current charge ceilings as fixed in

nominal terms and unlimited in their duration, which are exceptional. We first raised these concerns in our First Consultation in May 2008.

7.115 The arguments for maintaining a reduced notification date for MPF are:

- the total control period will only be now 23 months (from 1 May) and a 3 month notification for core rental charge change would have a substantial impact on Openreach returns against a service which is already under-recovering. This is not in the interest of sustaining competition in this market.
- the proposed charge change in the first year is at the low end of the range proposed in the first consultation and stakeholders would be expected to have anticipated an increase of at least this level and consider the impact of passing on the costs.
- this is only one of the charges controls which is being modified by the review. As the remainder of the charges will still be subject to a three month notification, the impact of the increases will be minimised.
- MPF is largely purchased by companies with direct relationship to the end customer, so the requirement to allow time for a third party to notify charge changes is reduced.
- given that Condition FA5.2 already provides that the obligation for prior notification does not apply where new charges are dictated by Ofcom, we consider a 28 day notice period strikes a reasonable balance between our policy objectives and the issues raised by the respondents.
- finally, with respect to the Talk Talk proposition that CPs should have time to consider remedial actions including appeal, we do not consider that the intention of notification period is to allow an opportunity for CPs to undertake remedial actions including an appeal. The charges are notified for administrative purposes and to allow adjustments by the market only.

7.116 We have decided not to modify the notification period for the remaining charges in the baskets as we considered that it was not possible for Openreach customer to anticipate the exact changes to their charges given the inherent flexibility in the basket controls.

The section 49(2) test

7.117 In light of the above, we are satisfied that the Consent meets the criteria prescribed by section 49(2) of the Act, namely it is:

- objectively justifiable in relation to the networks, services or facilities to which it relates;
- not such as to discriminate unduly against particular persons or a particular description of persons;
- proportionate to what it is intended to achieve; and
- in relation to what it is intended to achieve, transparent.

- 7.118 In particular, we consider that the Consent is objectively justifiable to control BT's charge for MPF rental with effect with 28 days notice after 22 May 2009 for reasons discussed above, including the relatively low increase and the focus on a single charge.
- 7.119 The Consent is not unduly discriminatory. It applies to all CPs, including BT itself, who have been notified of the final charge for MPF rental through the publication of this Statement. Nor did any respondents suggest that our proposals would be discriminatory, if adopted.
- 7.120 We also consider the Consent is proportionate in that we have given maximum period possible for requiring BT to provide an Access Charge Change Notice between the publication of this Statement and the new charge controls taking effect. Accordingly, we have reached the view that the Consent is necessary to reach our policy aims and also the least burdensome to address effectively the concerns we have set out. In so doing, we have taken into account and decided that the Consent should only apply on the first occasion BT seeks to amend its MPF rental charge to reflect the new charge control and that other charges and any further amendments to the MPF rental will remain subject to the requirements under Condition FA5.
- 7.121 We are also satisfied that the Consent is transparent in relation to what it is intended to achieve. Its aims and effect are clear and the Consent has been drafted so as to secure maximum transparency. The text of the Consent itself has also been published with this Statement and its intended operation should be aided by our explanations in this Statement.
- 7.122 Finally, we also consider that our decision to give this Consent takes due account of our policy in general on giving consent to reduced price change notice periods. In particular, Ofcom sent a letter to certain industry stakeholders on 11 October 2004 outlining its proposed approach to giving consents to shorter notification periods.¹⁵ In that letter, we said that, in relation to price changes directed by Ofcom, we would generally consult on the implementation arrangements (including a possible consent to a reduced notice period) when we consult on the substance of a direction. By direction, the letter referred to the scenario when Ofcom might be asked to consent to price changes taking effect more swiftly than is normally permitted, particularly where we direct a provider to alter prices forthwith. In that case, we said that consultation at an early stage should ensure that any issues are addressed and, if appropriate, notice of the price change is given.
- 7.123 Whilst we are not giving a direction in this Statement, we are in effect replacing the charge ceilings imposed by way of directions with a charge control under a new SMP condition. We therefore believe that the point about stakeholders' early notice as a result of consultation is consistent with the approach we have taken in consulting on the proposals leading to this Statement, in light of the circumstances on this case.

¹⁵ This letter has been published by Ofcom on numerous occasions, see for example at Annex 1 to the Statement entitled "Waiver of BT's price notification requirements for certain of BT's WES, WEES and BES prices", as published on 30 January 2009.