FAMR / LLU Charge Control

TalkTalk response to Openreach's submissions regarding QoS and LLU charge control

Non-confidential version

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1 Introduction

1.1 This response briefly provides comments on certain parts of BT's and Openreach's submission to Ofcom's 16 December 2013 and 16 January 2014 regarding LLU charge control and QoS. We have already provided comments on BT Group's submission regarding on price differences in a submission to Ofcom on 13 March 2014 (titled: "*LLU charge control. TalkTalk reply to BT response on price differential and Plum Consulting's report*").

2 Base year costs

2.1 This section provides TalkTalk's brief response to the elements of BT's submission dated 18 February 2014 dealing with base year data for charge control modelling (section 5 of BT's response). TalkTalk believes that BT has no valid case that the allocation approach used in the 2012/13 Regulatory Financial Statements ('**RFS13**') should be used. As set out in our previous submissions to Ofcom, BT has engaged in thorough gaming of the RFS, and the Primary Accounting Documents ('**PAD**') and Detailed Attribution Methodology ('**DAM**') which they are based on.

2.2 In its submissions, BT presents no additional evidence to that previously provided to Ofcom. Rather, it continue to assert aggressively that Ofcom should use the revised allocations, while presenting no evidence that demonstrates that the revised allocations are appropriate. In fact, as set out in both TalkTalk's earlier submissions and the BRG report dated December 2013, the majority of the changes made to the allocations either do not improve cost causality, or BT has provided so little data into the public domain that it is unclear whether the revised allocation is more cost causal or not.

2.3 Indeed, TalkTalk's position remains that the changes made to allocations in RFS13 are, in the main, not more cost causal and are primarily designed to increase BT's profits while harming its downstream rivals (by, for instance, double recovering costs). This is particularly clear in the case of the changes to BT TSO allocations, which have no semblance of improved cost causality.

2.1 Ofcom has no need to look at changes individually

2.4 BT's asserts arrogantly that Ofcom must use BT's most recent RFS13 as the starting point for assessing costs (used to set charges) unless it reviews and rejects each of BT's individual allocations. This is incorrect. Ofcom is fully entitled to take a holistic view on the appropriateness of allocations as a whole, and, where there are significant flaws in allocations, reject the allocation approach as a whole. Indeed, it is within Ofcom's discretion to ignore the allocations in the RFS in their entirety if it wishes to do so, and instead substitute allocations which have never been used by BT. There is no presumption (in law or otherwise) that BT's RFS should be used as the starting point for assessing costs.

2.5 This is particularly the case where the great majority of changes in allocation reduce cost causality, as is the case when considering changes between RFS12 and RFS13. Where Ofcom would have to make wholesale changes to the RFS (including reversing out the impact of the changes in TSO allocations, the impact of the specific group provision, the costs of employees in the career transition centre, removing duct costs from any allocations based on pay and weighted assets, along with a range of other changes), it is entitled to conclude that the effort required to do so is disproportionate, and that previous allocations represent a better approach than BT's current proposals.

2.2 Using RFS13 allocations will not increase economic efficiency

2.6 In section 5.1 of its submissions, BT makes the claim that using the allocations in RFS13 ("the latest available FAC information") as the basis on which to set prices will result in economically efficient prices. This is wrong.

2.7 BT asserts that:

> *Ofcom accepts that fully allocated cost ("FAC") information provides an economically efficient basis for setting charge controls and that it should use the latest available information when making regulatory decisions. (§27)*
>
> *To not use the 2012-13 published RFS, without clear and objective justification, will: (i) result in controls that are not economically efficient (§32)*
>
> *Ofcom has clearly stated in numerous charge control consultations that the use of FAC data is the most appropriate means of meeting economic efficiency objectives for a multi-product firm like BT where common costs will be significant and will need to be recovered (p37, §5)*

2.8 BT's contention that FAC costs are inherently economically efficient is misplaced. There is nothing about FAC costs which ensures that they generate economically efficient costs (except inasmuch as they ensure full recovery of all incurred costs). Whether FAC costs are economically efficient depends on whether they only include efficient forward looking costs and whether the allocations are based on cost causality. If inappropriate costs (e.g. deafness claims) are included and/or the cost allocations are not causal (e.g. HR and procurement costs being allocated on basis of weighted assets) then FAC costs will be neither economically efficient nor a good basis for setting prices. Furthermore, as set out at §2.1 above, Ofcom has no legal obligation to use the RFS data and BT has no right to insist that Ofcom uses it.

2.9 As set out in our earlier submission regarding BT's RFS[1], we consider that the RFS have been thoroughly gamed by BT, and bear little resemblance to an appropriate cost allocation to use for setting prices. As such, we consider even RFS12 to be a flawed basis for allocating costs; RFS13 is manifestly worse. As set out in our February 2014 submission to the Regulatory Financial Reporting review, we believe

[1] BT's Regulatory Financial Statements: [TalkTalk] submission on changes proposed by BT. 10 December 2013 http://stakeholders.ofcom.org.uk/binaries/consultations/llu-wlr-cc-13/responses/TalkTalk_Group_BTs_Regulatory_Financial_Statements.pdf

that Ofcom needs to remove BT's discretion and undertake a fundamental review of allocations before the RFS become usable again. The latest RFS is an abysmal source for suitable cost data on which to base prices.

2.10 Given the state of the RFS, we do not believe that there is any reliable and recently available FAC data for Ofcom to use. As such, reverting to an earlier period for FAC data is the most appropriate approach for Ofcom to adopt (though we still see problems in these earlier allocations).

2.3 BT has made changes to RFS13 which are not related to cost causality

2.11 BT correctly identifies, at §16, that cost allocations should be changed when there is the possibility of adopting a different cost allocation which leads to a greater reflection of the causes of those costs. TalkTalk considers that it is appropriate that cost causality is above consistency in the ordering of regulatory accounting principles.

2.12 However, at §17 of its submission, BT then goes on to identify various "*drivers of change in allocation methodologies*", several of which have no relation to cost causality:

- data changes may be able to lead to allocation changes which improve cost causality where they result in improved data which permits allocations to be undertaken which could not previously be undertaken. They will never be cost causal where the data change is a reduction in available data. If such changes are permitted, BT is liable to change the data it collects in order to be able to allocate more costs to regulated products.
- organisational changes should never lead to changes in cost allocations which increase the cost allocated to any product. BT asserts that "management and organisation changes alter the way in which costs may be shared across services"– however, it is unclear why (if by 'shared' BT means allocated) management and organisation changes should alter the appropriate allocation.
  - The costs of a product should never increase due to reorganisations (as is the case under BT's proposals); if the allocation to a product(s) increases due to an internal reorganisation, then by definition the reorganisation has led to avoidable cost increases, which BT should not be remunerated for.
  - There is no reason as to why the level of incremental cost caused by a product (such as MPF) would change as a result of a re-organisation.
  - There is, moreover, no obvious reason why the genuinely common costs allocated to various products should depend upon BT's internal structure from time to time. That BT is arguing this shows the deficiencies of the current allocation approach.

- Rightly, 'organisational change' does not appear on the (long) list in the PAD that describes the principles for determining how costs should be allocated.

- technological changes may indeed lead to changes in cost allocations. However, such changes should only lead to reductions in the costs allocated to regulated products. If a technological change leads to an increase in the total cost allocated to a regulated product, then by definition it cannot be efficient, and should not be taken into account by Ofcom.[2]
- market changes seem unlikely to lead to cost causal changes in allocations. BT seems to be referring in its drafting on this point to cross elasticities of demand acting as a cost causal driver of allocations; if this is indeed BT's point (as the drafting is unclear) then TalkTalk disagrees that this is a relevant driver of cost causal allocations. The RFS does not aim at Ramsey pricing.

2.13 In TalkTalk's view, BT considers far too wide a range of changes to potentially be "cost causal". The most important change in allocations based on cost causality should be where improved data becomes available; other changes appear, in general, to be unlikely to be cost causal unless the preceding methodology was egregiously inappropriate.

2.4 TalkTalk has no confidence in the change control process

2.14 At §§19-21 of its submission, and in Section 3 of the February 14th paper from FTI Consulting, BT discusses its change control process. The relevance of this is unclear in the context of the LLU charge control, rather than in the RFS review.

2.15 Notwithstanding the lack of relevance of this point, TalkTalk would like to emphasise that we do not consider that the existing change control process is robust. BT's pointing to its internal committees as a potential barrier to inappropriate changes is laughable, particularly in the absence of any publication of the membership of these committees, minutes of their meetings, details of the initial proposals submitted to them, or anything else which might allow any element of transparency. TalkTalk considers that BT employees will primarily be concerned about maximising BT's profits, which will both please more senior members of BT staff, and ensure that staff bonuses, profit shares, and share options have their value maximised. As such, we consider that these groups are likely, explicitly or implicitly, to aim to game the RFS to BT's advantage.

2.16 We also do not consider that the regulatory audit offers any reassurance to third parties, given TalkTalk's understanding of the terms under which it is conducted, and the history of failure of the audit to detect even clear errors – for instance, the audit

[2] This needs to be seen in net terms. For example, a particular cost may initially be £100,000, of which 20% is applied to a particular regulated product. If the total cost was reduced by a technological change to £80,000, then any amount up to 25% allocation to that regulated product could be efficient; whereas if the technological change left the total cost unchanged at £100,000, then no more than 20% of this cost could be allocated after the technological change.

permitted allocating BT Group costs such as HR and procurement on the basis of weighted assets when such an allocation basis is clearly not causal and as such is inconsistent with the PAD. Given that we consider the PAD and DAM to be unfit for purpose, any audit based on determining whether accounts are in accordance with the PAD or DAM will be irrelevant. The many serious flaws in those documents will naturally feed through into the outcome of the audit.

2.17 Even if these flaws were not present in the PAD and DAM, TalkTalk would still be concerned about placing too much reliance on an audit of this type. We consider that PwC may be biased in favour of BT's judgement, due to BT's control of appointment of PwC as its auditor. As the Competition Commission has recently found:

> *the FD [Finance Director] retains an influential role in the decision to appoint or reappoint the auditor. The FD is also responsible for the company's financial reporting and is the respondent to the auditor in the conduct of the audit. It follows that if an auditor performs well (in the eyes of executive management) then it knows that it is more likely to be reappointed and so has strong incentives to meet executive management demand.*[3]

2.18 In this case, TalkTalk believes that there is likely to be considerable pressure on PwC to accept BT's proposed cost allocations, and that these pressures are likely to be greater even those in statutory audits. In statutory audits, the auditors are only concerned with the manner in which accounts are presented– they do not impact the ability of the firm being audited to make profits. On the other hand, an audit of RFS allocations can have direct impacts on BT's wholesale prices, revenues and profitability. The conflict of interest facing auditors is therefore even greater than for statutory audits. PwC is likely to be deemed by BT to be performing well if it provides BT with an unqualified audit opinion year after year, as indeed has occurred despite clear errors being identified post-audit.

2.19 We further believe that BT is likely to abuse its (substantial) margin of discretion in deciding cost allocation rules and preparing the RFS, as envisaged by the Competition Commission:

> *despite extensive developments in regulation, there remains a degree of judgement in selecting and applying accounting treatments, and FDs will at times have strong incentives to choose the most favourable application. We think that while ACs [audit committees] provide support for auditors to form an independent judgement from FDs, FDs still have the opportunity to influence the work and judgements of auditors on some issues*[4].

2.20 In the case of an audit of the RFS, there is little regulation beyond that applied by Ofcom, and there does not appear to be an independent audit committee chaired by an independent non-executive director, as exists for firms' statutory accounts.[5]

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[3] Competition Commission (2013), *Statutory audit services for large companies market investigation*, paragraph 11.187

[4] Competition Commission, *op. cit,* para 11.189

[5] See http://www.btplc.com/Thegroup/Ourcompany/Governance/AuditCommittee/ where BT sets out in detail that its audit committee consists entirely of independent non-executive directors.

Again, there are likely to be more serious biases in this process than exist even in the audit of statutory accounts.

2.21 As such, TalkTalk considers that PwC is likely to be subject to a combination of explicit and implicit pressure to adhere to the allocations proposed by BT. We consider the audit, whether at FPIA or at any other level, to offer no meaningful or reliable comfort as to the appropriateness of the allocations. Ofcom should reject any assertion by BT that the audit process guarantees, or even tends to support, an appropriate allocation.

2.5 The reallocation of costs in RFS13 is inappropriate

2.22 BT asserts at section 5.5 of its submission that Ofcom has not provided views on whether RFS13 is inappropriate for regulatory purposes. TalkTalk's view on this is clear– RFS13 has little or no value for regulatory consideration, as it is so thoroughly biased towards overallocating costs towards regulated products.

2.23 TalkTalk believes that there are numerous problems with RFS13, which are not simply limited to the double-recovery issue referred to by BT at §26 of its submission, where the same cost is recovered in more than one charge control. We also have concerns about shifting costs from unregulated to regulated products, and unjustifiably changing the allocation of a set of costs over time, so the same costs are recovered more than once from the same product(s). These are outlined more fully in our earlier response regarding the RFS13[6]. We note that BT has not responded at all to these points.

2.24 As such, even if Ofcom were not concerned about recovery of the same costs across two different charge controls (which it should be), it would still be adhering to its statutory duties by rejecting the RFS13 in its entirety.

2.6 The changes in allocation of BT TSO costs are inappropriate

2.25 At section 5.6, BT attempts to argue that the reallocations of costs due to BT TSO's creation are justified. This appears to represent the high water mark of BT's case in favour of RFS13. However, the arguments advanced by BT merely go to demonstrate the weakness of the case for RFS13's proposed reallocations in their entirety .

2.26 At the outset, TalkTalk would note that we are not in a position to determine independently whether there is interdependence between the changes to the allocation for BT TSO and other changes.[7] We therefore do not comment on this topic.

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[6] BT's Regulatory Financial Statements: [TalkTalk] submission on changes proposed by BT. 10 December 2013 http://stakeholders.ofcom.org.uk/binaries/consultations/llu-wlr-cc-13/responses/TalkTalk_Group_BTs_Regulatory_Financial_Statements.pdf

[7] That is, whether the changes to the TSO allocation would themselves result in a need to change the allocations of other cost categories within the RFS, or vice versa.

2.27 TalkTalk believes, however, that the changes in TSO costs lack any semblance of improvement to cost causality – indeed BT has advanced no evidence or analysis that shows that the allocation change would result in a more causal allocation. They should therefore be rejected by Ofcom; and should be rejected even in the case where Ofcom has no concerns regarding interdependence or double recovery.

2.28 We consider that, as set out above at §4.2, internal reorganisations should never lead to the costs caused by a product increasing. The products offered by BT, and the requirement for resources to produce those products, should not have changed as a result of the reorganisation. As such, there should be no additional allocation to WLA products due to the creation of BT TSO. As BRG notes:

> *BT Technology, Service and Operations (TSO) was created from the merger of BT innovate and design and BT operate which has resulted in significant cost allocation changes. A reorganisation should not significantly change the cost of providing products and services. The products remain unchanged and the staff and resources used for the products are also likely to remain largely unchanged.*

2.29 BT does not actually make any arguments in §§36-39 of its submission as to why a reorganisation should impact on the cost of providing products. At §36, it argues that BTO and BTID applied different allocation methodologies to similar types of costs, and that changes were therefore required to make the allocation methodologies more consistent. However, this provides no explanation as to why the new allocation methodology is better than either of the previous approaches by being more causal.

2.30 At §38 BT argues that '*it would not have been a balanced response*' to the creation of TSO not to change cost allocations. No evidence is provided in support of this assertion, which we disagree with.

2.31 Finally, at §39, BT argues that the methodology changes *'only affected a subset of the total cost*'. While this may be true, it is irrelevant. The additional costs allocated just to WLA as a result of this change amount to £32m per annum. It is astonishing that BT appears to be implying that Ofcom should not concern itself with changes of this magnitude.

2.32 TalkTalk also notes that even Deloitte's report appears to have some concerns over aspects of the TSO changes. Referring to TSO development costs (where an additional £16m per annum is allocated to WLA), Deloitte states that:

> *The methodology seems appropriate from a cost causality perspective, although in some instances the previous methodologies could be argued to be more cost causal.*[8]

2.33 Deloitte further notes that:

> *Over 21% of development costs were previously identified as 21CN specific, rather than BTO overheads*.[9]

[8] Deloitte (2013), at Table 29.
[9] Deloitte (2013), at Table 28.

2.34 That Deloitte, despite this admission, found that the revised methodology on balance meets the cost allocation principles demonstrates both the inappropriateness of these principles, and the lack of independence of Deloitte's conclusions.[10]

2.35 As regards double recovery, it is instructive that BT states at §41 that:

> *Looking at the TSO methodology changes in isolation, the impact upon the recently closed leased line charge control is approximately only £1million.*

2.36 BT appears to here be trying to argue that where it receives clearly identifiable excess profits of "only" £1m per annum, which are unrelated to efficiency gains, then this should be below some implicit *de minimis* threshold that Ofcom should apply. This is wrong, inappropriate, and self-serving, and Ofcom should ignore it. It clearly demonstrates BT's contempt for the regulatory process and for Ofcom's duty to protect consumers' interests.

3 Faults and QoS

3.1 This section discusses various aspects of BT / Openreach's comments regarding faults and Quality of Service (QoS) /minimum service standards.

3.1 Historic and future fault levels

3.2 We consider it is striking that Openreach is not able to offer any reliable or robust evidence that properly explains the huge increase in faults (1 million extra faults or a 50% increase between 2009 and 2012). Rather its submission is once more peppered with rainfall charts, picture of floods and anecdotes about the problems of operating in a wet climate. TalkTalk[11] has shown, based on Ofcom's evidence, that increases in rainfall and increased uptake of broadband can only explain a small fraction of the increase in faults[12]. Given the amount of analysis of faults that Openreach appears to have undertaken we would expect that if there was a genuine reason for the increase in faults (aside of lack of preventative maintenance and NGA roll-out), then Openreach would have found and highlighted it. This leads to the natural conclusion that either there is no good reason for the increase in faults (aside of lack of maintenance and NGA), or that BT does not want to disclose the good reason since it would act against BT's interests. Ofcom's implicit assumption that the current level of faults is efficient effectively gifts BT the 'benefit of the doubt', which, given BT's information advantage, is inappropriate.

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[10] We note that when TalkTalk asked to see Deloitte's terms of reference, BT refused point blank while suggesting we should complain to Ofcom if we had concerns about this issue.

[11] See TalkTalk response to 16 Dec 2013 consultation at §4.6

[12] Openreach also argue §275 that there is an increased use of broadband particularly less 'fault tolerant services. However, most of these broadband 'faults' would pass SIN349 and therefore would be charged separately and therefore the cost of these would not be included in MPF/WLR rental charges

3.3 At §17 of its submission Openreach presents a forecast of future fault levels which is based on 'projecting current fault rate trends'. We find it astonishing that Openreach is projecting increased fault rate levels into the future when it cannot provide any reliable or credible explanation of the substantial increase in the past four years. The forecast appears to have been derived by little more than using a ruler on the past trend to derive continually increasing fault rate levels. Ofcom should ignore these forecasts – it is wrong to include unexplained historic cost increases in the base year costs since it would reward BT for engaging in inefficient behaviour. It would be even more wrong to assume that BT's performance continues to deteriorate and become yet more inefficient. We also note that it appears that BT projections are based on continuing (and increasing) high rainfall levels (see §19) whereas the forecast should be based on average / expected rainfall.

3.4 Openreach argues (§38) that late reporting of faults[13] is both placing 'increasing pressure on Openreach resources' and cannot be supported based on the cost levels permitted in the current charge control. We consider that Openreach is confusing current behaviour and changes in behaviour. Provided the level of late reporting remains the same (and Openreach is not suggesting that it is likely to increase) then, all else equal, there is no reason to expect late reporting to cause any increase in costs. Rather, if late reporting is reduced (by for instance having, as Openreach suggest, an earlier cut-off) then fault repair costs would fall and, as such, the MPF/WLR cost should be reduced. Indeed, Openreach appears to suggest that Ofcom supports an earlier (6pm) cut off, which would lead to a reduction in late reporting. In this case, either the cost (and price) will reduce or a higher minimum service standard (for repairs) should be imposed but with no additional cost.

3.5 Openreach argues (at §7) that 2012/13 and 2013/14 should be used as the base years to set fault costs because they are 'more representative in term of the impact of weather'. This is wrong – these years had higher than average levels of rainfall and so (on the basis of Openreach's own arguments) the fault levels were inflated above the expected level. Ofcom should adjust forecast fault costs to be consistent with *average* rainfall, by first determining the expected rainfall based on long-term trends (i.e., 1981-2010 data) and then deriving the number of faults which would be expected at this level of aggregate rainfall.

3.6 Openreach provides data (below §13) that shows that the level of ILF and ELF faults for WLR+SMPF is 4% greater than for MPF. Openreach says of this (§304):

> *… Ofcom is not correct to simply align MPF to be equal to WLR+SMPF. There are a number of quite legitimate factors which explain a difference between fault rates on different products. MPF and SMPF have been and will continue to be used by different customers in different ways, with different approaches to customer service and associated processes, which will give rise to different tendencies to report faults using different Openreach service offerings. The <u>small but significant difference</u> in the historic data for these line types supports that view.*

[13] According to Openreach this refers to examples where faults that need to be repaired next working day (as for care level 2) are reported late in the day (e.g. after 6pm)

3.7 Thus, from above, it can be seen that the combined ILF and ELF fault rate is greater for WLR+SMPF than MPF. Therefore, given that MPF will have many more ELF faults than WLR+SMPF (since there is more provisioning activity per line), this reinforces TalkTalk's view that WLR+SMPF ILF rates are significantly greater than for MPF lines[14].

3.8 We note that Openreach (at §14) argues that NGA faults should be included in the charges for MPF and WLR – we disagree. NGA faults (i.e. faults that are caused by the roll-out/provision of NGA) must not be included in MPF or WLR charges since they are not caused by these products. Given BT Retail's very high share of fibre lines on the Openreach network, any recovery of NGA faults from copper lines would be economically inefficient and mean that TalkTalk, Sky and EE would subsidise BT Retail's fibre customers.

3.9 Openreach claims (at §37) that CPs are not supporting efforts to engage in process improvement activities that would reduce the number of faults. Openreach claims that this is because the change is not in CPs' interests and that Ofcom should encourage CPs to be more supportive. Such a criticism is hypocritical – Openreach has publicly stated that it only progresses SOR requests from CPs that are in Openreach's commercial interests. In any event, TalkTalk for one is supportive of process improvements since lower fault rates benefit our customers.

3.2 Cost of higher quality

3.10 At §150 Openreach seems to suggest that the (incremental) network investment cost should be greater for higher quality e.g. care level 2 versus care level 1. We see no cogent justification for this. The level of network investment made for a copper line will be the same irrespective of care level. The impact of better care levels will merely be a change in the cost of repairing the line (after a fault occurs), due to the speed with which the repairs need to be undertaken. We are not aware of Openreach ever investing greater amounts in lines that have a higher care level.

3.11 What Openreach's comment might reflect is that in their RFS BT allocate a higher proportion of network investment cost to lines with higher care levels. Of course, the problem here is not Ofcom's approach to assessing the incremental cost of higher care levels, but rather BT's RFS which has been gamed to inflate the costs allocated to MPF providers. If there is a greater allocation of network investment cost to MPF lines, TalkTalk believes that the correct approach for the RFS would be for Ofcom to adjust the RFS so as to equalise the network investments allocated to different types of lines (i.e. the RFS should follow the regulatory decision).

3.12 At §337 Openreach discuss the need for a 'lower usage factor' of e-side and d-side for SMPF. It is not clear why usage factors (which are used to allocate costs in the RFS) are relevant to Ofcom's assessment of the incremental cost of higher quality of service. Openreach also mention usage factors in §345. Again, this appears to reflect Openreach treating the RFS allocations as if they genuinely reflected costs caused,

[14] We discussed this in TalkTalk response to 16 Dec 2013 consultation at section 4.2.2

rather than arbitrary allocations of costs which have been decided in BT's commercial interest.

3.3 Minimum service standards

3.13 Openreach's first comment (at §39) on minimum service standards is that the SLA/SLG regime is rigorous and consequently that minimum service standards are not necessary. This is simply untrue. The SLA/SLGs are of limited scope, as can be seen by the long list of requests for additional SLA/SLGs from CPs. Further, where SLA/SLGs do exist they do not fully cover the losses that CPs incur as a result of poor performance by Openreach; and anyway are insufficient to incentivise good performance, since inadequate performance has persisted even with SLA/SLGs in place. UK consumers need Ofcom to impose (and enforce) stringent minimum service standards as soon as possible.

3.3.1 Ofcom's approach of giving Openreach a force majeure allowance

3.14 In setting the actual level of minimum service standard Ofcom has provided a 'force majeure allowance'. The logic for this appears to be that it was better to have a fixed minimum service standard that did not vary depending on (say) the level of adverse weather events.

> *In the July 2013 FAMR Consultation we considered whether faults and provisioning orders affected by Openreach's force majeure, or MBORC, declarations should be included or excluded from the minimum standard. We considered that including faults and orders affected by these events would have good incentive properties and would make compliance obligations more straightforward. We therefore proposed that the minimum standards should include a reasonable allowance for force majeure events [§3.90]*

3.15 We agree that the minimum service standard / level must reflect the impact of force majeure type events (such as adverse weather) and that a fixed minimum service standard should be set.

3.16 Ofcom have reflected the impact of force majeure events by taking the *actual* KPI performance of BT[15] (Ofcom proposes using a mid-case of 80%) and then deducting an 'MBORC allowance' (3% for repair and 1% for provision) to give a minimum service standard of 77% for repair and 79% for provision. Openreach's costs are based on performance at 80%.

[15] The lower bound appears based on actual KPIs in 2011/12 (see §3.37) e.g. 77.7% repair and 65% provision. The upper bound is based on KPIs for 2009/10 e.g. 85% for repair; there was no actual data for provisions to SLA in 2009/10 but Ofcom has used an upper bound of 100% (see §3.48, footnote 45, §3.50)

3.17 We think Ofcom's approach is incorrect since the actual KPI performance (of 80%) already includes the impact of force majeure events such as adverse weather – thus Ofcom has double counted[16] the impact of bad weather[17].

3.18 Furthermore, and in any event, Ofcom is wrong to base Openreach's costs on a performance of 80% but then only require Openreach to achieve 77%. The minimum service standard should be set at the same level as is used to set costs otherwise Openreach will be able to achieve excessive profit. This is material – if Openreach's (repair) service performance was assumed to be 77% (and not 80%) MPF rental prices would fall by about £0.10[18]. Ofcom should therefore reduce permitted MPF rental prices by this amount if it sets a minimum service standard of 77%.

3.3.2 Openreach's alternative options

3.19 Openreach suggests (at §122) that rather than using a pre-set MBORC allowance, compliance should be tested against a level that reflects the *actual* MBORC declaration rate. We presume this to mean that if (say) the 'basic' performance is set at 80% then the minimum service standard is 80% less the actual MBORCs declared so that if MBORCs were 6% the minimum service standard would be 74%. We think such an approach would be detrimental to consumers' interests for a number of reasons:

- This system would permit Openreach to game the regulatory system – declaring more MBORCs so that the minimum standard that it needs to reach is reduced. It is notable here that, as far as we understand, Ofcom has never assessed whether Openreach's approach to declaring MBORCs is reasonable (e.g. whether they genuinely reflect force majeure events or whether it is beyond Openreach's control to achieve better performance). We do not accept, as a matter of principle, that most MBORCs reflect force majeure events.
- The system becomes less straightforward and clear for all participants.
- If this were done there would be very weak incentives for Openreach to deliver good service once an MBORC is declared in a particular area since they know that the poor service they deliver does not count for their performance against minimum standards.

[16] If Ofcom wishes to include an explicit force majeure allowance, then it should adjust the actual KPI performance of BT upwards to exclude the impact of force majeure events. The force majeure allowance should then be deducted from this higher figure. The cost should then be set to be consistent with the minimum service standard

[17] If Ofcom's intention was to provide some headroom for extreme force majeure conditions then we consider that Ofcom's approach is inappropriate for three reasons. First, extreme levels of force majeure events can be taken into account when compliance is tested. Second, there is no reason to use the actual level of MBORCs as the basis for allowing for this. Third, there is no reason to base the costs on the 80% service level when the target is below 80%.

[18] See consultation table 3.2. Moving form 80% to 75% reduces MPF rental by £0.16

- If there is genuinely extreme weather that makes it genuinely impossible to achieve the minimum service standard then this can be taken into account when assessing compliance and/or the level of BT's fine for non-compliance.
- In any case, MBORCs are already allowed for in the 80% figure so there is no need to make any further adjustment.

3.20 Openreach suggests (at §123) a variation on this approach whereby 'spikes' in missed jobs where MBORCs apply are not counted when assessing compliance with the minimum service standard. For the same reasons as above this would also be a bad approach.

3.21 More generally we note that the only real effect or impact of MBORCs is that they allow Openreach to avoid paying SLGs (and Openreach games the declaration of MBORC to meet its own commercial advantage). Therefore they do not provide any meaningful reflection of whether there is force majeure type events and accordingly they should not be given any more credence or role than they have today.

3.3.3 Local minimum service standards

3.22 Openreach repeatedly mention the difficulty of meeting minimum service standards in each region and, for that reason argue for a reduction in the minimum service standard. We believe that the same standard should apply in each region. However, if Ofcom were to consider relaxing the standard then the only objectively justifiable approach would be to retain the national minimum service standard at 80% (say) and then set each local minimum service standards slightly lower – say 78%[19]. This would allow local minimum service standards to reflect local conditions and variations (e.g. adverse weather).

3.3.4 On time appointment standard

3.23 In figure 10 Openreach provides information on the level of engineering visits completed on the appointed date (for WLR). The SLA here is 90% whereas nationally the average performance is 92% to 93%. Ofcom has set the minimum service standard at 90%. We consider that, based on this evidence, Ofcom should set a higher minimum service standard since it is clear that Openreach can achieve a higher level than Ofcom has assumed in its consultation.

3.3.5 'Glidepath' to minimum service standard

3.24 Openreach repeatedly plead that the new minimum service standards should be gradually introduced by, for instance, the standard in 2014/15 being based on the bottom of Ofcom's range. For example, they say that that a high target in year 1 "*will inevitably result in failure to hit the targets due to exogenous factors and providing Openreach insufficient time to develop its capability to successfully deliver*

[19] The cost should be based on the national minimum service standard.

against the minimum standards." (§210). Ofcom should ignore such a claim. First, Openreach can easily meet a higher level by adding slightly more resource – for instance increasing from 75% to 80% requires just 1.7% more resource[20]. Such a small increase in capacity can be easily and quickly achieved through e.g. recruitment, more overtime etc. Second, the 'exogenous' factors Openreach highlight are unspecified (and, in the absence of any or further explanation of what they are, should be assumed not to exist).

4 Other aspects of charge control

4.0 Price differential

4.1 Openreach argues that the £10 reduction in the incremental cost difference between MPF and WLR+SMPF (i.e., the £10-£14 estimate in the 2012 Statement reduced to £0-£4 in December 2013 Consultation) is "*is mostly driven by Ofcom decisions to exclude evoTAM costs from SMPF and to only attribute TAMs to MPF*". This is simply not correct since the majority of the change is due to changes in the cost estimates. A comparison of the cost differences[21] shows that:

- £3.50 of the reduction is due to a reduction in the line card incremental cost estimate (£7.50 vs £11);
- £2.20 is due to an increase in the estimated cost of the higher MPF care level (£2.23 vs £0);
- £4.00 of the reduction is due to an increase in the estimated cost of MPF testing equipment (£5.10 vs £1.10). This included TAM, evoTAM and tie cables;
- none of the difference is a result of a change in TAM attribution since in 2012 all the incremental cost of the TAM was 'attributed' to MPF (as it is now).

4.2 Thus the change in cost differential has been driven by a change in Ofcom's cost estimates rather than a change in Ofcom's policy. This change in cost estimates could not have been foreseen by market participants.

4.1 Efficiency

4.3 Openreach says regarding the efficiency assumption (at §309):

> *Best practice dictates that a balance should be struck between the 'carrot' under a price control (making over-achievement possible) and the 'stick' (requiring efficiency improvements to recover costs). The target should be challenging, but the target should not be such that "yet further savings" over and above the target cannot be identified and realised*

[20] From Table 3.2 in the 16 December 2013 consultation
[21] Fig 7.9 in 2012 Statement compared to Table 7.3 in December 2013 Consultation

4.4 Openreach once again seems to have misunderstood the impact of the efficiency assumption. The cost minimisation incentive inherent in a charge control results from the price being effectively fixed and so the regulated company being able to increase profit by reducing cost. The profit impact from marginal cost reductions is not dependent on the actual price level (but rather the regulated price not changing in response to short-term cost changes). Therefore, the cost minimisation incentive does not depend on the level of price or the efficiency assumption. Rather the level of the efficiency assumption and price is important since it determines BT's ability to recover its efficiently incurred costs. The efficiency assumption should reflect the likely / expected level of efficiency improvement that BT could achieve if it were acting efficiently.

4.5 We also note that Openreach compares itself to other European operators (§59). Such comparisons are almost irrelevant since these other operators are incumbent monopolies who have weak incentives for cost minimisation. Therefore they are very poor indicators of what efficient cost levels are.

4.2 Review of model

4.6 Openreach provides a number of detailed comments on the model (see section 4.10). Other stakeholders are not able to make comments on the detailed modelling since the models are highly redacted. We consider that such an approach is asymmetric and will tend to lead to bias in regulatory outcomes.

4.3 Expedite services

4.7 Openreach agrees (at §369) with Ofcom's proposals to remove expedite services from charge controlled baskets since "*… these are premium service products, for which Ofcom has no robust cost information.*" This is neither a sound nor a sufficient reason not to impose charge controls. The fact that a service which offers higher quality and is something Openreach describes as 'premium' is an invalid reason for not imposing a charge control. Second, the absence of robust cost information cannot be a sound reason for not imposing a charge control, not least since it provides Openreach with an incentive to not prepare cost information in order to avoid regulation. This would create a perverse moral hazard.

4.4 Basket design

4.8 Openreach argues that the basket structure which has been designed to prevent BT gaming the basket is inappropriate, since there is no evidence of BT actually having gamed the baskets. We have two points to make in this regard:

- First, Openreach seems to have ignored that the purpose of *ex ante* regulation is to <u>prevent</u> abuse arising (where there is a risk that it may arise) rather than to put a stop to problems after they have been identified. Throughout its submissions, BT does not appear to recognise the difference

between *ex ante* and *ex post* regulatory structures, and to inappropriately push for effects based analysis within an *ex ante* framework (i.e. that *ex ante* regulation should only be imposed after abuse has been shown to occur). Ofcom should reject such submissions as inappropriate and wrong.

- Second, it is very difficult for stakeholders to identify and prove gaming of the charge controls since they do not have the information available to do so. Openreach must be aware that this is the case. We have suggested in our response to Ofcom's RFS consultation[22] that more information should made available so that gaming (if it exists) can be identified more easily by other market participants.

4.5 Deafness costs

4.9 Openreach makes a long-winded, incoherent and ultimately irrelevant argument (at §447 to §449) as to why actual deafness claims costs should be included in regulated charges (or a notional charge to insure against the same deafness claims costs). BT is being economically illiterate – the deafness claims are not caused by the provision of existing products and therefore they are not a forward looking cost. To suggest otherwise is ridiculous. It does not matter how the cost is dressed up – the same principle applies. TalkTalk, Sky, EE and other external downstream customers of Openreach should pay none of the costs of deafness claims.

[22] See TalkTalk response to 16 Dec 2013 consultation at §7.13