



Final determinations concerning re-determination of disputes relating to BT's charges for Ethernet services (remitted by the CAT)

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Issue date: 4 May 2017

About this document

In December 2012 Ofcom resolved five disputes between BT and each of Cable & Wireless Worldwide (now Vodafone), Sky, TalkTalk, Verizon and Virgin concerning BT's charges for Ethernet services. We found that BT had overcharged these parties approximately £95 million for Ethernet services during the period 2006/07 to 2010/11. Ofcom's determinations of these disputes were appealed to the Competition Appeal Tribunal (the "CAT").

In August 2014, the CAT issued its judgment on the appeals. Whilst the CAT rejected the appeals in large part, it remitted two issues to Ofcom for determination, including the rate of interest payable in respect of BT's overcharge for Ethernet services.

This document sets out Ofcom's final conclusions for determining the remitted matters.

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Glossary of terms

2003 Act: The Communications Act 2003.

The Altnets: CWW, Verizon and Virgin.

BT: British Telecommunications PLC whose registered company number is 01800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006.

CAT: The Competition Appeal Tribunal.

CDS: Credit default swap. A CDS is a form of insurance against possible default on a debt.

CP: Communications provider.

CWW: Cable & Wireless Worldwide plc (whose registered company number is 7029206) group, including the following CWW companies: Cable & Wireless UK (registered company number 1541957), Cable & Wireless Access Limited (registered company number 4005262), Energis Communications Limited (registered company number 2630471), Thus Group Holdings Limited (registered company number SC192666) and Your Communications Group Limited (registered company number 4171876).

The Disputing Parties: CWW, Sky, TalkTalk, Verizon and Virgin.

ECCs: Excess construction charges. A charge that BT levies where the installation of an Ethernet circuit requires extra work.

The Ethernet Determinations: The five determinations issued on 20 December 2012 to resolve disputes between BT and each of CWW, Sky, TalkTalk, Verizon and Virgin concerning BT's charges for Ethernet services.

The Ethernet Disputes: Five disputes between BT and each of CWW, Sky, TalkTalk, Verizon and Virgin concerning BT's charges for Ethernet services.

Ethernet services: Services that provide dedicated transmission capacity at a range of bandwidths between sites.

The Final Determinations: This document.

The Gamma Determination: A determination to resolve a dispute between BT and Gamma Telecom Holdings Limited relating to the "Ofcom Interest Rate" contained within BT's Standard Interconnect Agreement issued by Ofcom on 25 October 2013.

The Interest Guidance: Guidance published by Ofcom as part of the Gamma Determination setting out Ofcom's approach to interest in the context of resolving disputes involving charges payable under the SIA, which provides an indication of the interest rate that we are generally likely to adopt in such cases.

The Judgment: The CAT's judgment on the appeals of the Ethernet Disputes, handed down on 1 August 2014.

The Orders: Three Orders issued by the CAT to give effect to the Judgment and Supplementary Judgment, issued on 10 December 2014.

The Parties: BT, CWW, Sky, TalkTalk, Verizon and Virgin.

The Provisional Conclusions: The document issued on 22 June 2015 which set out our provisional conclusions for determining the Remitted Matters.

The Remitted Matters: The matters that the CAT remitted to Ofcom in the Orders.

SIA: BT's Network Charge Change Control Standard Interconnect Agreement, which provides the terms and conditions on which calls are connected between BT and other CPs.

Sky: Sky UK Limited whose registered company number is 02906991, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006.

SMP: Significant Market Power.

The Supplementary Judgment: The CAT's supplementary judgment, handed down on 4 December 2014.

TalkTalk: TalkTalk Telecom Group PLC whose registered company number is 07105891, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006.

Vanilla WACC: A way of calculating weighted average cost of capital that uses the pre-tax cost of debt and the post-tax cost of equity.

Verizon: Verizon UK Limited whose registered company number is 02776038, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006.

Virgin: Virgin Media Limited whose registered company number is 02591237, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006.

Vodafone: Vodafone Limited whose registered company number is 01471587, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006.

WACC: Weighted average cost of capital.

Section 1

Summary

- 1.1 On 20 December 2012, Ofcom issued five determinations (the “Ethernet Determinations”)¹ resolving disputes between British Telecommunications plc (“BT”) and each of Sky UK Limited (“Sky”),² TalkTalk Telecom Group plc (“TalkTalk”), Virgin Media Limited (“Virgin”),³ Cable & Wireless Worldwide plc⁴ (“CWW”),⁵ and Verizon UK Limited (“Verizon”)⁶ (together the “Parties”). The Ethernet Determinations found that BT had overcharged each of CWW, Sky, TalkTalk, Virgin, and Verizon (together the “Disputing Parties”) for certain Ethernet services from 2006/07 to 2010/11. The Ethernet Determinations ordered BT to repay to the Disputing Parties a total of £94.8 million.⁷
- 1.2 Three appeals (the “Appeals”) of the Determinations were lodged with the CAT: by BT;⁸ by Sky and TalkTalk (jointly);⁹ and by CWW, Virgin and Verizon (jointly) (the “Altnets”).¹⁰
- 1.3 On 1 August 2014, the CAT handed down its judgment (the “Judgment”) on the Appeals.¹¹ The CAT upheld Ofcom’s decision that BT had overcharged the Disputing Parties but found that:
- Ofcom should have made an adjustment to BT’s rental costs in 2009/10 in respect of the exclusion of excess construction charges (ECCs); and
 - Ofcom should have ordered BT to pay interest on the repayments.
- 1.4 On 10 December, the CAT issued three Orders (the “Orders”),¹² which remitted the following matters to Ofcom (the “Remitted Matters”):
- a) the rate of interest payable in respect of BT’s overcharge for Ethernet services;
 - b) the repayments to which BT is entitled in respect of the exclusion of ECCs from its rental costs;

¹ http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/annexes/Ethernet_FD.pdf

² At the time of the Ethernet Determinations, Sky was known as British Sky Broadcasting Limited.

³ http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/closed-cases/all-closed-cases/cw_01052/

⁴ CWW was acquired by Vodafone on 30 July 2012.

⁵ http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/closed-cases/all-closed-cases/cw_01078/

⁶ http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/closed-cases/all-closed-cases/cw_01087/

⁷ The Ethernet Determinations, paragraph 15.153.2.

⁸ <http://www.catribunal.org.uk/239-7889/1205-3-3-13-British-Telecommunications-PLC.html>

⁹ <http://www.catribunal.org.uk/239-7925/1207-3-3-13-1-British-Sky-Broadcasting-Limited-and-2-TalkTalk-Telecommunications-Group-plc-.html>

¹⁰ <http://www.catribunal.org.uk/239-7924/1206-3-3-13--1-Cable--Wireless-Worldwide-plc-2-Virgin-Media-Limited-and-3-Verizon-UK-Limited-.html>

¹¹ <http://www.catribunal.org.uk/238-8608/Judgment.html>

¹² http://www.catribunal.org.uk/files/1206_Cable_Order_101214.pdf; http://www.catribunal.org.uk/files/1205_BT_Order_101214.pdf; and http://www.catribunal.org.uk/files/1207_BSkyB_Order_101214.pdf

- c) BT's claim for interest in respect of the repayment referred to at (b); and
 - d) the total amount payable as between BT and Sky, TalkTalk, and the Altnets.
- 1.5 We opened a case on 3 February 2015 to determine the Remitted Matters.
- 1.6 On 22 June 2015 we issued a document setting out our provisional conclusions (the "Provisional Conclusions") on the Remitted Matters.
- 1.7 This document (the "Final Determinations") sets out our final conclusions on the Remitted Matters.

The Provisional Conclusions

- 1.8 On 22 June 2015 we issued our Provisional Conclusions, in which we proposed to determine that:
- 1.8.1 Adjusting for the ECC overpayment, the correct amount of principal overcharge by BT should be £94,620,000.
 - 1.8.2 The corrected figure above took account of the repayment that BT is entitled to in respect of the exclusion of ECCs of £203,000.
 - 1.8.3 The interest on the corrected principal overcharge payable by BT should be £22,422,000.
 - 1.8.4 The net amount which BT should repay to the Disputing Parties (i.e. the interest less the ECCs adjustment) should be £22,219,000; and
 - 1.8.5 From 29 December 2012, BT should pay interest on the net amount due to the Disputing Parties at a rate of Bank of England Base Rate plus 1% (BoE+1%).
- 1.9 We also proposed that from 29 December 2012, BT was entitled to interest on the ECC overpayment. By calculating a net amount due to the Disputing Parties, and allowing for interest on that net amount only, BT's entitlement would be given effect to in the Provisional Conclusions.

Ofcom's Final Determinations

- 1.10 We received three responses to our Provisional Conclusions. BT, Towerhouse (on behalf of the Altnets) and Herbert Smith Freehills (on behalf of Sky and TalkTalk) each provided a response. The Disputing Parties also provided a joint report by AlixPartners in response to our Provisional Conclusions.
- 1.11 In reaching our final conclusions, we have carefully considered those responses. In Section 4, we summarise the responses to our Provisional Conclusions, our responses to the issues that were raised, and our final determination of the Remitted Matters.
- 1.12 We have determined that:
- 1.12.1 Adjusting for the ECC overpayment, the correct amount of principal overcharge by BT is £94,620,000.

- 1.12.2 The corrected figure above takes account of the repayment that BT is entitled to in respect of the exclusion of ECCs of £203,000.
 - 1.12.3 The interest on the corrected principal overcharge payable by BT is £22,422,000.
 - 1.12.4 The net amount which BT should repay to the Disputing Parties (i.e. the interest less the ECCs adjustment) is £22,219,000; and
 - 1.12.5 From 29 December 2012, BT should pay interest on the net amount due to the Disputing Parties at a rate of Bank of England Base Rate plus 1% (BoE+1%).
- 1.13 From 29 December 2012, BT is entitled to interest on the ECC overpayment. By calculating a net amount due to the Disputing Parties, and allowing for interest on that net amount only, we have given effect to BT's entitlement to interest on the ECC overpayment.

Structure of the remainder of this document

- 1.14 The introduction and background are set out in **Section 2** and the analysis underpinning our provisional reasoning and assessment is set out in **Section 3**. Our final conclusions, including consideration of the submissions from stakeholders in responses to our provisional conclusions, are set out in **Section 4**.
- 1.15 **Annex 1** provides a table setting out the interest payments on the principal overcharge by year and **Annex 2** is a copy of Ofcom's guidance on its approach to interest in the context of resolving a dispute involving charges payable under BT's Standard Interconnect Agreement.
- 1.16 The determinations to resolve the Remitted Matters are set out in **Annexes 3 to 7**.

Section 2

Background

2.1 In this section, we set out the relevant background to this case, including a summary of the Ethernet Disputes, the Appeals and guidance published by Ofcom on its approach to the award of interest in the context of a previous dispute determination.

The Ethernet Disputes

2.2 On 27 July 2010, Sky and TalkTalk made a joint submission to Ofcom asking us to resolve disputes with BT concerning BT's charges for Ethernet services. Virgin submitted a dispute on 10 August 2010, CWW submitted a dispute on 17 November 2011 and Verizon submitted a dispute on 22 February 2012. We accepted the Sky, TalkTalk and Virgin disputes for resolution on 13 September 2010 (the "Initial Disputes"),¹³ the CWW dispute on 9 December 2011,¹⁴ and the Verizon dispute on 15 March 2012.¹⁵

2.3 The services in dispute in the Ethernet Disputes were Wholesale Extension Services (WES) and Backhaul Extension Services (BES). WES and BES are types of wholesale Ethernet services. They provide dedicated transmission capacity at a range of bandwidths between sites. WES are used by CPs to provide a dedicated fibre optic data circuit between a retail customer's premises and the CP's network. BES are fibre optic data circuits that run between a CP's network and its equipment within an unbundled BT local exchange. They are used by Local Loop Unbundling operators.

2.4 In market reviews in 2004 and 2008, Ofcom found that BT had significant market power (SMP) in the alternative interface symmetric broadband origination (AISBO) market, which included the provision of wholesale Ethernet services. Based on this finding, Ofcom imposed an SMP condition on BT (Condition HH3.1) which required BT to ensure that its charges for services (including Ethernet services) were cost oriented, and to be able to demonstrate this to Ofcom's satisfaction.¹⁶

2.5 In the Ethernet Disputes, the Disputing Parties contended that BT had overcharged for Ethernet services in breach of Condition HH3.1 and that BT should be ordered by Ofcom to repay to them the amount of the overcharge.

2.6 The Disputing Parties argued that Ofcom should require BT to repay interest on any repayment.¹⁷

¹³ Disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT's charges for Ethernet services (CW/01055/08/10).

¹⁴ Dispute between Cable and Wireless and BT about BT's charges for Ethernet services (CW/01078/11/11).

¹⁵ Dispute between Verizon and BT relating to BT's charges for WES (CW/01087/02/12).

¹⁶ Condition HH3.1 required that BT: "*shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition HH1 is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.*"

http://stakeholders.ofcom.org.uk/binaries/consultations/llmr/statement/state_note.pdf and

<http://stakeholders.ofcom.org.uk/binaries/consultations/bcmr08/summary/bcmr08.pdf>

¹⁷ The Ethernet Determinations, paragraph 15.74.

- 2.7 Each of the Ethernet Disputes concerned different services and periods:
- 2.7.1 TalkTalk and Sky's dispute concerned certain BES services from 24 June 2004 to 31 July 2009.
 - 2.7.2 Virgin's dispute concerned certain BES and WES services from 1 April 2006 to 31 March 2009.
 - 2.7.3 CWW's dispute concerned certain BES and WES services from 1 April 2006 to 31 March 2011.
 - 2.7.4 Verizon's dispute concerned certain WES services from 1 January 2007 to 31 March 2011.
- 2.8 We therefore considered whether BT had overcharged the Disputing Parties for Ethernet services during the period between 24 June 2004 and 31 March 2011.
- 2.9 As part of our analysis we made a number of adjustments to the financial data included in BT's published regulatory financial statements (RFS), which we used as the basis of our analysis of whether BT had overcharged. One of these was to remove the costs associated with Excess Construction Charges (ECCs), a charge that BT levies where the installation of an Ethernet circuit requires extra work. BT submitted that Ofcom should reduce the adjustment it had made for ECCs in 2009/10, as the costs associated with ECCs had already been removed from the financial data supplied by BT for that year.¹⁸
- 2.10 On 20 December 2012, Ofcom issued the Ethernet Determinations to resolve all of the disputes. The Ethernet Determinations found that BT had overcharged each of the Disputing CPs in breach of Condition HH3.1 and required BT to make repayments for the total amount of the overcharge.
- 2.11 We considered that we did not have sufficient evidence to decide whether we should also award interest, which would involve setting aside the contractual provision, in order to meet our regulatory objectives. Therefore, no order was made for interest to be paid.¹⁹
- 2.12 Following the Ethernet Determinations, BT issued credit notes to each of the Disputing Parties on 28 December 2012 for the amounts that Ofcom had ordered BT to repay.²⁰

The Interest Guidance

- 2.13 On 25 October 2013, Ofcom issued a determination (the "Gamma Determination") to resolve a dispute between Gamma Telecom Holdings Limited and BT (the "Gamma Dispute") concerning the interest rate set out in BT's Standard Interconnect Agreement (SIA), known as the "Ofcom Interest Rate", which applied, among other things, to any repayments required as a result of a direction by Ofcom.²¹

¹⁸ The Ethernet Determinations, paragraphs 13.194 and 13.199 to 13.200.

¹⁹ The Ethernet Determinations, paragraphs 15.74 to 15.144.

²⁰ BT's 19 February 2015 response to Ofcom's 1st Section 191 Notice.

²¹ See http://stakeholders.ofcom.org.uk/binaries/enforcement/competition-bulletins/closed-cases/all-closed-cases/cw_01108/CW_011080613.pdf

- 2.14 As part of the Gamma Determination, Ofcom issued guidance (the “Interest Guidance”) in which it indicated its general approach to interest in the context of resolving disputes involving charges payable under the SIA,²² and “*sought to identify the interest rate that we are generally likely to adopt*” in such cases.²³ The Interest Guidance is included at Annex 2 of this document.
- 2.15 The Interest Guidance states that it is likely to be appropriate to award interest in the majority of cases in which we order repayment, our main objective being to avoid creating an incentive for CPs to set charges that are unduly high. The Interest Guidance also says that the starting point is that the interest rate should generally reflect the time value of the principal to the overcharging firm, i.e. the benefit the overcharging firm enjoys by virtue of the delay between its overcharging and the date on which it makes a repayment.²⁴
- 2.16 The Interest Guidance states that it would be reasonable to expect that the opportunity cost to the overcharging firm reflects the cost of debt as it could repay outstanding debt or avoid taking out debt with an additional increase in cash as a result of the overcharge. This implies that a cost of debt rate would be appropriate.²⁵ We explained that the interest rate which would represent the cost of debt to the overcharging firm is determined by two factors: (a) the term of the debt; and (b) the premium over and above the risk-free rate which reflects the risk of default by the overcharging firm.²⁶
- 2.17 We also explained in the Interest Guidance that although we could seek to assess on a case-by-case basis the *actual* benefit to the overcharging firm as a result of the overcharge in that case, such an in-depth assessment would be complex and is unlikely to be practical. We also noted that it is important to adopt an approach which would foster commercial and regulatory certainty and that an appropriate interest rate should be readily calculable using available data.²⁷
- 2.18 We stated that:
- “We therefore do not consider that it would be appropriate to seek to assess the actual benefit to the overcharging firm in the context of resolving a dispute. Instead, in view of the difficulties which may be involved in seeking to determine a ‘theoretically accurate’ rate which approximates the actual benefit to an overcharging CP in a particular case, we consider that it is reasonable and proportionate to adopt a more pragmatic approach, provided that the applicable rate would be within the range of the cost of debt to the overcharging CP that may reasonably be expected.”²⁸*
- 2.19 We explained that we considered that BoE+1%²⁹ is likely to be an appropriate rate to reflect the benefit derived by the overcharging firm from the overcharge in most

²² The charges for the relevant services in the Ethernet Disputes were not payable under the SIA. However, as noted at paragraph 4.14 of the Gamma Determination, we consider that the Interest Guidance is also relevant more generally to repayments directed by Ofcom.

²³ Gamma Determination, paragraph A2.2.

²⁴ Gamma Determination, paragraphs A2.3 to A2.4.

²⁵ Gamma Determination, paragraph A2.8.

²⁶ Gamma Determination, paragraph A2.8.

²⁷ Gamma Determination, paragraph A2.9-10.

²⁸ Gamma Determination, paragraph A2.11.

²⁹ We noted that this is the rate which has conventionally been adopted by the High Court in commercial cases and by the CAT when awarding interest on penalties on appeal.

cases.³⁰ However, we recognised that, depending on the facts of the case and taking into account any evidence provided by the Parties, it may be appropriate to adopt a different rate in order to ensure that our objectives are met.³¹

The Appeals

- 2.20 In February 2013, BT,³² Sky and TalkTalk (jointly),³³ and the Altnets (jointly)³⁴ lodged appeals against the Ethernet Determinations.
- 2.21 On 1 August 2014, the CAT handed down its judgment on the Appeals (the “Judgment”).³⁵ The CAT substantially upheld Ofcom’s decision that BT had overcharged the Disputing Parties and dismissed most of BT’s and Sky and TalkTalk’s grounds of appeal, but found that:
- Ofcom should have made an adjustment to BT’s rental costs in 2009/10 in respect of the exclusion of ECCs,³⁶ and
 - Ofcom had jurisdiction to require a payment of interest and should have ordered BT to pay interest on the repayments.³⁷
- 2.22 On 10 December 2014, the CAT issued three orders (the “Orders”) giving directions. The CAT remitted to Ofcom in accordance with section 195(4) of the 2003 Act the following matters for Ofcom to determine, as soon as reasonably practicable,³⁸ in accordance with the Judgment and the Supplementary Judgment:³⁹
- a) the rate of interest payable in respect of BT’s overcharge for Ethernet services;
 - b) the repayments to which BT is entitled in respect of the exclusion of ECCs from its rental costs;
 - c) BT’s claim for interest in respect of the repayment referred to at (b); and
 - d) the total amount payable as between BT and Sky, TalkTalk, and the Altnets.
- 2.23 Section 195(6) of the 2003 Act requires Ofcom to comply with every direction given by the CAT under section 195(4) of the Act. We therefore opened this case in order to determine the matters remitted to us by the CAT.

³⁰ Gamma Determination, paragraph A2.12.

³¹ Gamma Determination, paragraph A2.13.

³² Case number , see <http://www.catribunal.org.uk/239-7889/1205-3-3-13-British-Telecommunications-PLC.html>

³³ Case number , see <http://www.catribunal.org.uk/239-7924/1206-3-3-13--1-Cable--Wireless-Worldwide-plc-2-Virgin-Media-Limited-and-3-Verizon-UK-Limited-.html>

³⁴ Case number , see <http://www.catribunal.org.uk/239-7924/1206-3-3-13--1-Cable--Wireless-Worldwide-plc-2-Virgin-Media-Limited-and-3-Verizon-UK-Limited-.html>

³⁵ See http://www.catribunal.org.uk/files/1205-7_Ethernets_Judgment_CAT_14_010814.pdf

³⁶ The Judgment, paragraphs 214 to 220 and 316(a).

³⁷ The Judgment, paragraphs 286 to 315 and 316(b).

³⁸ Order of the CAT, case no. 1206/3/3/13 and Order of the CAT, case no 1207/3/3/13.

³⁹ See http://www.catribunal.org.uk/files/1205-7_Ethernets_Judgment_CAT_20_041214.pdf

The current case and the Remitted Matters

- 2.24 On 29 December 2014, we wrote to the Parties inviting them to provide submissions on the Remitted Matters, as well as the relevance of the Interest Guidance in this case. The Parties provided submissions on 2 February 2015. On 3 February 2015, we published details of the case, including the scope, on the Competition and Consumer Enforcement Bulletin part of our website.⁴⁰
- 2.25 We have made determinations in accordance with the terms of the Orders, as set out at Annexes 3-7 of this document.

Interested parties

- 2.26 One stakeholder, KCOM Group, has expressed an interest in the outcome of this dispute.

Information relied upon in determining the Remitted Matters

- 2.27 These Final Determinations draw on information provided by the Parties. This includes:
- 2.27.1 BT submission, 2 February 2015;
 - 2.27.2 Report prepared for Vodafone, Virgin, Verizon, Sky and TalkTalk by AlixPartners concerning the rate of interest repayable on overcharge by BT relating to Ethernet Services (the “Alix Report”), 2 February 2015;
 - 2.27.3 Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015;
 - 2.27.4 Towerhouse submission on behalf of Vodafone, Virgin and Verizon, 2 February 2015;
 - 2.27.5 BT’s 19 February 2015 response to Ofcom’s Section 191 Notice;
 - 2.27.6 BT submission, 18 March 2015;
 - 2.27.7 Report prepared for BT by Ernst & Young LLP on the rate of interest repayable on the overcharges by BT relating to Ethernet services (the “Ernst & Young Report”), 18 March 2015;
 - 2.27.8 Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 16 March 2015;
 - 2.27.9 Report prepared for Vodafone, Virgin, Verizon, Sky and TalkTalk by AlixPartners concerning the rate of interest repayable on overcharge by BT relating to Ethernet Services (the “second Alix Report”), 16 March 2015;
 - 2.27.10 Towerhouse submission on behalf of Vodafone, Virgin and Verizon, 18 March 2015;

⁴⁰ http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/open-cases/all-open-cases/cw_01149/

- 2.27.11 BT's response to the Provisional Conclusions, 17 July 2015;
- 2.27.12 Towerhouse's response to the Provisional Conclusions on behalf of Vodafone, Virgin and Verizon, 17 July 2015;
- 2.27.13 Herbert Smith Freehills' response to the Provisional Conclusions on behalf of Sky and TalkTalk, 17 July 2015;
- 2.27.14 Report prepared for Vodafone, Virgin, Verizon, Sky and TalkTalk by AlixPartners in response to Ofcom's Provisional Conclusions (the "third Alix Report"), 17 July 2015.
- 2.27.15 Email from BT to Ofcom concerning provisions, 10 August 2015

Section 3

Analysis and provisional conclusions

Introduction

3.1 This section sets out our provisional reasoning and analysis on which we consulted in June 2015. In Section 4 we set out the submissions we received in response to our Provisional Conclusions, as well as our final decisions.

The correct level of principal overcharge

Introduction

3.2 The CAT ordered us to determine the repayments that BT is entitled to with respect of the exclusion of ECCs (see paragraph 2.22 above). We proposed to do this by adjusting our original calculation of BT's overcharge to account for ECC costs in 2009/10.

Parties' views

3.3 In an email from BT dated 5 September 2014, BT supplied its calculations of the correct amount of overcharge by BT to Ofcom, taking account of the adjustment for ECC costs. BT's calculations are set out in Table 3.1.

Table 3.1 Corrected total overcharge by CP (£)

	2006/07	2007/08	2008/09	2009/10	2010/11	Total
Sky	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
TalkTalk	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Virgin	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
CWW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Verizon	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total CPs	[✂]	[✂]	[✂]	[✂]	[✂]	94,620,000

Source: Email from BT to Ofcom, Towerhouse and Herbert Smith Freehills, 5 September 2014⁴¹

⁴¹ Email from BT to Ofcom, Towerhouse and Herbert Smith Freehills, 5 September 2014

- 3.4 BT said that it appeared that all of the Parties⁴² have agreed with the corrected figures that have been supplied to Ofcom and the parties, and that Ofcom should therefore make an adjustment accordingly.⁴³
- 3.5 The Disputing Parties confirmed that they had agreed with BT the repayments to which BT is entitled in respect of ECCs.⁴⁴

Our analysis

- 3.6 On 9 September 2014, we wrote to BT and confirmed that the figures provided on 5 September 2014 were consistent with our own calculations of the adjustments and that we would be content to agree a direction for Ofcom to re-determine the Ethernet Disputes by amending the amount of the repayments due by BT to take account of the CAT's approach to ECCs in the Judgment.⁴⁵
- 3.7 We therefore considered that the repayments should be amended in line with BT's 5 September 2014 adjustments.
- 3.8 Table 3.2 sets out the repayments that we provisionally concluded were due to BT from the Disputing Parties reflecting the adjustment to the principal overcharge relating to ECCs.

Table 3.2: Amounts due to BT for ECCs adjustment (£)

	2006/07	2007/08	2008/09	2009/10	2010/11	Total
Sky	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
TalkTalk	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Virgin	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
CWW	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Verizon	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]
Total CPs	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	203,000

Source: Ofcom. Calculated as the difference between Table 3.1 and Table 15.1 from the Ethernet Determinations.

Provisional conclusion on the correct level of overcharge

- 3.9 We provisionally concluded that, taking into account the adjustment in respect of ECCs, the correct amount by which BT overcharged the Disputing Parties was £94,620,000.

⁴² BT refers to an email from Towerhouse to BT dated 12 September and a letter from Herbert Smith Freehills to BT dated 11 September 2014 as evidence of the agreement of the Disputing Parties to BT's recalculations.

⁴³ BT submission, 2 February 2015, paragraph 55 and footnote 60.

⁴⁴ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015, paragraph 3; Email from Towerhouse to Ofcom, 8 June 2015.

⁴⁵ Email from Ofcom to BT, 9 September 2014.

- 3.10 We therefore provisionally concluded that, taking account of the adjustment in respect of ECCs, the amounts which BT should have repaid to the Disputing Parties are as set out in Table 3.1

The appropriate rate of interest on the principal

Introduction

- 3.11 The Ethernet Determinations did not order BT to pay interest on the overcharge. The Judgment found that Ofcom should have ordered BT to pay interest on the overcharge and ordered Ofcom to determine the rate of interest payable in respect of BT's overcharge for Ethernet services.
- 3.12 We therefore considered the appropriate level of interest to be applied in respect of the overcharge which BT was required to repay in the Ethernet Determinations. In doing so, we had regard to the Interest Guidance, as appropriate.
- 3.13 We also considered:
- whether interest should be simple or compound; and
 - if compound, at what intervals interest should be awarded.

BT's view

- 3.14 BT argued that it would be a "*fundamental error*" to depart from the "*clearly settled*" principle set out in the Interest Guidance, that the interest rate should reflect the time value of the principal to the overcharging firm.⁴⁶
- 3.15 BT argued that having conducted a detailed and extensive review in the Gamma Determination and having laid out clear guidance in the form of the Interest Guidance, "*it would now be contrary to regulatory practice and commercial certainly for Ofcom to depart from applying the Gamma Determination appropriate rate (i.e. Base Rate plus 1%) as the interest rate in this specific case, unless there were truly exceptional circumstances (which there are not).*"⁴⁷
- 3.16 BT also argued that the period of time for which it held the overcharge in this case (from 2006/07 until December 2012) is not a reason to depart from the Gamma Determination. Noting that the original dispute was submitted in July 2010 and accepted by Ofcom in September 2010, BT argued that it could reasonably have expected to have had to repay the overcharge within the next four months. BT considered that the fact that it took Ofcom a further two years to reach its final determination should not be seen as a reason to assume that BT would have used the money for longer term deposits or to reduce longer term debt, since it could reasonably have expected that it would need to repay the money in a much shorter period.⁴⁸

⁴⁶ BT submission, 2 February 2015, paragraph 7.

⁴⁷ BT submission, 2 February 2015, paragraph 10.

⁴⁸ BT submission, 2 February, paragraphs 21 and 22.

- 3.17 Although BT said that Ofcom should award interest at BoE+1%, it argued that the actual benefit of the overcharge to BT was likely to be less than BoE+1%.⁴⁹
- 3.18 BT observed that between 2006 to 2013, it had a substantial cash surplus in excess of one billion pounds in all but two years.⁵⁰ It argued that even accounting for the total overcharge in the market (which did not arise in a single year) the “*overcharge would not have so reduced BT’s cash liquidity that it would have induced further borrowing.*”⁵¹
- 3.19 Ernst & Young, in their report on behalf of BT, assessed the counterfactual situation, specifically whether there would have been any differences in BT’s cost of financing its operations and/or its capex programme. They considered that “*we need to assess which part of BT’s funding was “subsidised” during the period of overcharging, by virtue of BT not incurring financing costs in respect of the overpayments when it would, absent the overpayments, be expected to do so.*”⁵²
- 3.20 With respect to BT’s WACC, Ernst & Young argued that BT had a significant amount of cash and cash equivalents during the period of the overcharge, and that “*these amounts were sufficiently large that it is reasonable to conclude that its overall financing requirements could have been funded in full without recourse to the equity or debt markets in the event that it had not received overpayments in respect of its ethernet services.*”⁵³
- 3.21 With respect to BT’s capex, Ernst & Young stated that they “*would expect that the amount that BT invested in capital projects from year to year would be determined not by the amount of funds to which it has access (since this can be increased or decreased to meet demands) but, rather, by the number and size of financially viable projects available to the company.*”⁵⁴
- 3.22 Considering which elements of BT’s financing would be different in the counterfactual, given the context of BT’s financial position, Ernst & Young considered three alternatives for the benefit received by BT from the overcharges.
- 3.22.1 **Overall cost of capital:** Ernst and Young said that “*BT’s WACC reflects the respective financing costs of both debt and equity funding. The debt consists of a variety of instruments but, in general, a common characteristic of debt financing instruments is a finite term to maturity, i.e., the point at which the principal is required to be repaid. In contrast, equity funding represents an investment which is usually considered longer term in nature and is typically subject to more uncertain returns. What is clear is that BT’s benefit was limited to a period of approximately five years or less and, as such, was not a substitute for long term finance.*”⁵⁵
- 3.22.2 **Cost of debt:** Ernst and Young said that in the context of the overcharge, “*BT enjoyed the benefits of the overpayments for a finite term, which meant that in theory it could have required less debt to be raised as a*

⁴⁹ BT submission, 2 February 2015, paragraph 28.

⁵⁰ In 2011 and 2012, BT’s balance sheet showed respectively £370 million and £844 million of cash liquidity. BT submission, 2 February 2015, paragraph 29.

⁵¹ BT submission, 2 February 2015, paragraph 29.

⁵² Ernst & Young Report, 18 March 2015, paragraph 3.4.

⁵³ Ernst & Young Report, 18 March 2015, paragraph 3.6.

⁵⁴ Ernst & Young Report, 18 March 2015, paragraph 3.7.

⁵⁵ Ernst & Young Report, 18 March 2015, paragraph 3.11 (a).

*consequence of the overpayments. The interest rate on debt of a relevant maturity would seem to be the most appropriate approach to approximate the benefit to BT.*⁵⁶

3.22.3 **Cash and equivalents:** Ernst and Young said that another option to consider is that *“BT benefited from the overpayments by having additional cash deposits, rather than reducing its funding requirements.”*⁵⁷ They suggested that *“given this scale of available cash and the relatively short-term nature (relative to BT’s other forms of funding) of the period from the beginning of the overpayments to the date of the repayments, it may be reasonable to consider the cash deposit rates as a proxy for the benefit to BT.”*⁵⁸

3.23 Ernst & Young set out that:

*“...it seems clear that the overcharge is (i) finite in term and (ii) immaterial to BT’s financial operations and associated decision-making. This suggests, given the size of BT’s cash holdings, that an interest rate based on the cash deposit rate would represent a reasonable proxy for the benefit that BT could reasonably have expected to receive from the overpayments. We consider that an interest rate based on BT’s WACC can be rejected as inappropriate as it weights the benefit of the overcharge towards longer term financing, which is not consistent with the benefits which BT actually enjoyed as a result of the repayments.”*⁵⁹

3.24 Ernst & Young said that if Ofcom is to consider what an overcharging CP would have had a reasonable opportunity to do with the overcharge, *“then it is necessary to take into account at what point BT had a reasonable expectation of repayment.”*⁶⁰ They said that *“when considering the likely term of the debt, it is not obvious that it is appropriate to consider the period during which the dispute resolution process was extended for ‘exceptional reasons’.”*⁶¹

3.25 Ernst & Young considered that an appropriate estimate of BT’s short term debt is the sum of the relevant swap rate and a credit risk premium obtained by interpolating from a Credit Default Swap (CDS)⁶² curve.⁶³

3.26 Although they considered that an interest rate based on the cash deposit rate and estimated using swap rates and CDS curve is the best approximation for the benefit to BT, Ernst & Young considered that the Gamma rate of BoE+1% *“is close to the actual benefit BT obtained from overpayments”* and *“is consistent with some of the overpayments being used by BT to increase its cash position and some of it being used to avoid debt financing.”*⁶⁴ They concluded that, given the aim of ensuring commercial and regulatory certainty, the Gamma rate is a reasonable rate of interest

⁵⁶ Ernst & Young Report, 18 March 2015, paragraph 3.11 (b).

⁵⁷ Ernst & Young Report, 18 March 2015, paragraph 3.11 (c).

⁵⁸ Ernst & Young Report, 18 March 2015, paragraph 3.11 (c).

⁵⁹ Ernst & Young Report, 18 March 2015, paragraph 3.13.

⁶⁰ Ernst & Young Report, 18 March 2015, paragraph 3.18.

⁶¹ Ernst & Young Report, 18 March 2015, paragraph 3.18.

⁶² A CDS is a form of insurance against possible default on a debt and can therefore provide an estimate of the credit spread. A CDS curve shows the interest rate, or spread, of a CDS of varying maturities.

⁶³ Ernst & Young Report, 18 March 2015, paragraph 3.21.

⁶⁴ Ernst & Young Report, 18 March 2015, paragraph 3.24.

to apply in this case, “especially in view of the complexity of accurately estimating the actual benefit in cases such as these.”⁶⁵

- 3.27 BT accepted that interest should be compounded at yearly intervals. BT also stated that “it would be illogical to compound interest at any point other than when any new principal overcharge has accrued.”⁶⁶
- 3.28 BT said that “the only sensible legal analysis is that the overcharge must crystallise at the end of the year when the RFS period... comes to an end.”⁶⁷ If Ofcom rejects this approach, BT contended that no assumptions can be made as to how each overcharge is spread throughout the year, and therefore “the only sensible solution would be to take the mid-point in the year (i.e. 1 October).”⁶⁸

The Disputing Parties’ views

- 3.29 The Disputing Parties noted that in the Gamma Determination, Ofcom concluded that its primary objective in setting an interest rate is to avoid CPs having an incentive to set charges that are unduly high.⁶⁹ They agreed that Ofcom’s focus on an interest rate which avoids CPs having incentives to set unduly high charges is appropriate, and therefore that the appropriate interest rate should reflect the benefit to BT from the overcharge and put BT back in the position that it would have been in but for the overcharging.⁷⁰
- 3.30 The Disputing Parties said, however, that if Ofcom wishes to achieve the main objective set out in the Interest Guidance, we should base the interest rate on BT’s cost of capital rather than cost of debt as that reflects the benefit of the overcharge to BT.⁷¹
- 3.31 Sky and TalkTalk argued that the approach set out in paragraphs A2.8 to A2.14 of the Interest Guidance “should not in fact be Ofcom’s general approach” and, in any event, the approach of using the Bank of England base rate plus 1% as a proxy of BT’s cost of debt should not be adopted in this case.⁷²
- 3.32 The Altnets argued that “Ofcom should approach the question of the rate entirely afresh and without any preference for the Gamma rate.”⁷³
- 3.33 The Disputing Parties said that the appropriate interpretation of the overcharges in the Ethernet Disputes is that they led to an overall reduction in BT’s net financing

⁶⁵ Ernst & Young Report, 18 March 2015, paragraph 3.25.

⁶⁶ BT submission, 2 February 2015, paragraph 47.

⁶⁷ BT submission, 2 February 2015, paragraph 23.

⁶⁸ BT submission, 2 February 2015, paragraph 23.

⁶⁹ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015, paragraph 8-10, Towerhouse submission on behalf of Vodafone, Virgin and Verizon, 2 February 2015, paragraph 4.4, Alix Report, 2 February 2015, paragraph 3.2.2.

⁷⁰ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015, paragraphs 11-12, Towerhouse submission on behalf of Vodafone, Virgin and Verizon, 2 February 2015, paragraph 5, Alix Report, 2 February 2015, paragraph 3.2.3.

⁷¹ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015, paragraph 19, Towerhouse submission on behalf of Vodafone, Virgin and Verizon, 2 February 2015, paragraph 4.4, Alix Report, 2 February 2015, paragraph 3.3.13.

⁷² Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015, paragraph 13

⁷³ Towerhouse submission on behalf of Vodafone, Virgin and Verizon, 2 February 2015, paragraph 4.1.

requirement during the years in question.⁷⁴ Specifically, AlixPartners, in its report on behalf of the Disputing Parties, argued that, due to the overcharges, BT would have earned more revenue than it would have otherwise, meaning that BT had a “*reduced net financing requirement given the level of capital expenditure planned by BT.*”⁷⁵

- 3.34 AlixPartners argued that the principles of corporate finance demonstrate that there are both direct and indirect effects on the costs associated with a net financing requirement, and that the costs associated would not vary at the margin irrespective of the precise financing instrument that BT would avoid as a result of the overcharge. They argued that the Modigliani-Miller irrelevance theorem⁷⁶ “*explains that when the linkages between the cost of debt, the cost of equity and the level of gearing are all taken into account, the overall cost of financing is the same whether the firm issues debt, equity or a combination of both at the margin.*”⁷⁷ They argued that “*the overall cost associated with a change in the net financing requirement is equal to the cost of capital irrespective of the specific instrument used to fund it.*”⁷⁸
- 3.35 AlixPartners therefore said that the appropriate interest rate is BT’s WACC. The Alix Report said that the relevant WACC is the BT Group nominal vanilla WACC (which uses the pre-tax cost of debt and the post-tax cost of equity) estimated using the WACC parameters published by Ofcom in various reports from 2005 to 2013.⁷⁹ This is because:
- 3.35.1 BT’s treasury policy is carried out at a group level and any overcharge would lead to a change in the debt and equity mix at the BT Group level;⁸⁰
 - 3.35.2 since the repayment of the principal does not take account of inflation, a nominal WACC compensates the overcharged parties for the effects of inflation;⁸¹ and
 - 3.35.3 a vanilla WACC reflects the risk-adjusted discount rate applied by investors to cash flows earned by the firm.⁸²
- 3.36 The Disputing Parties set out that the facts of this case suggest that the overcharge was not akin to debt, but rather that the more appropriate interpretation is that the overcharge led to an overall reduction in the net financing requirement of BT.⁸³ AlixPartners (in their report on behalf of the Disputing Parties) cited their understanding of the relevant facts as:

⁷⁴ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015, paragraphs 18 to 20, Towerhouse submission on behalf of Vodafone, Virgin and Verizon, 2 February 2015, paragraph 4.4, Alix Report, 2 February 2015, paragraph 3.3.8.

⁷⁵ Alix Report, 2 February 2015, paragraph 3.3.12.

⁷⁶ Modigliani and Miller hypothesised that in perfect markets a firm’s WACC is not affected by the choice of financing (therefore the choice of capital structure is irrelevant). This is summarised in Annex 2 of the Alix Report.

⁷⁷ Alix Report, 2 February 2015, paragraph 3.3.16.

⁷⁸ Alix Report, 2 February 2015, paragraph 3.3.17.

⁷⁹ Alix Report, 2 February 2015, paragraphs 3.5.1 and 3.4.7.

⁸⁰ Alix Report, 2 February 2015, paragraph 3.4.14.

⁸¹ Alix Report, 2 February 2015, paragraph 3.4.16.

⁸² Alix Report, 2 February 2015, paragraph 3.4.18.

⁸³ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015, paragraph 15.2, Towerhouse submission on behalf of Vodafone, Virgin and Verizon, 2 February 2015, paragraph 4.3, Alix Report, 2 February 2015, paragraph 3.3.2.

- i) “Some of the overcharges started as early as 2006/7 and continued to 2010/11 (a period of five years);
- ii) Following Ofcom’s investigation into disputes submitted by various CPs, Ofcom published Provisional Determinations in February 2012 and the Determinations in December 2012;
- iii) BT made repayments to CPs following Ofcom’s Determinations. These repayments included only the principal overcharge, not interest on any basis;
- iv) Ofcom’s decision was appealed to the CAT by BT, and a Judgment was reached in August 2014. The CAT Judgment confirmed that overcharges had taken place on BES and WES services from 2006/07 to 2010/11 and that interest should be awarded on the overcharges;
- v) BT first recognised the Ethernet disputes outcome as a Specific Item in its financial statement for the year ending 31 March 2013.”⁸⁴⁸⁵

3.37 AlixPartners also stated that “even if BT had realised that an overcharge had occurred, at that time it would only be expected to be repaid if a series of events also occurred:

- i) “A party (most likely the regulator or the affected CPs) identifies that an overcharge has (likely) taken place. The CPs, however, may not have been aware that an overcharge has occurred;
- ii) Sufficient evidence arises for the CPs of the regulator to pursue the dispute; and
- iii) Ofcom accepts the dispute for resolution and reaches a finding that an overcharge has occurred which is either i) not appealed or ii) not overturned on appeal.”⁸⁶

3.38 AlixPartners argued that given the facts of this case, “it is difficult to see how the overcharge can be treated as substituting one debt (to CPs) for another, certainly at least until a liability was recognised in BT’s accounts.”⁸⁷ In order for the overcharge to be treated as a debt obligation from BT to the Disputing Parties, AlixPartners argued that there would have to be recognition of the overcharge when it occurred by each party and an explicit agreement for the repayment of the overcharge on agreed

⁸⁴ Alix Report. 2 February 2015, paragraphs 3.3.3 (i) - (v)

⁸⁵ BT says the issue of when a CP first recognised the potential liability was considered in the Gamma Determination, at paragraphs 4.57-4.60. In any event, BT say that the Alix Report is factually incorrect, as “when the 2013 accounts were published in May 2013, BT had **already** [BT’s emphasis] made payment for the overcharges determined by Ofcom on 20 December 2012, The statement in the accounts therefore relied upon in the Alix Report did not reflect BT recognising that for the first time it had a **contingent liability** [BT’s emphasis] to repay money, but BT’s acknowledgment that the sums **had already** [BT’s emphasis] been paid.” See BT submission, 18 March 2015, paragraph 38. BT also says that “it is quite clear that by May 2012 (when BT’s Financial Statements for the year end 31 March 2012 accounts were published with BT’s Annual Report), no express provision for the contingent liability of the overcharges was published. This reflects the fact that the sums in question (i.e. amounts approximately equivalent to the overcharge finally determined by Ofcom in December 2012) were deemed to be not sufficiently material that they required express provision in BT’s published accounts.” See BT submission, 18 March 2015, paragraph 39.

⁸⁶ Alix Report. 2 February 2015, paragraphs 3.3.4 (i)-(iii).

⁸⁷ Alix Report. 2 February 2015, paragraph 3.3.5.

terms. They also said that other characteristics of debt do not apply, for example that it is reported as a liability on the balance sheet and that it would have seniority in the event of bankruptcy proceedings.⁸⁸

- 3.39 Sky and TalkTalk and the Altnets also argued that it is relevant that BT has contended that it should not have to make repayments, as this suggests that at the time of the overcharge BT would not have expected to make repayments, and that therefore this is a further reason that the nature of the overcharge is not akin to debt.⁸⁹
- 3.40 In the event that Ofcom considered it appropriate to use a cost of debt approach, AlixPartners argued that BT's cost of debt should be estimated by reference to BT's outstanding debt during the relevant period, taking account of the market conditions that BT faces.⁹⁰
- 3.41 AlixPartners proposed that the average yield to maturity over each of BT's relevant financial years is a reasonable estimate of BT's cost of debt.⁹¹ Given that BT held multiple bonds of differing values and volumes, *"the annual average should be weighted by the contribution of each bond to the total outstanding stock of bonds in that year."*⁹²
- 3.42 In the event that Ofcom decided that a cost of debt rate is appropriate and should be derived by reference to a risk-free rate plus a credit-spread,⁹³ AlixPartners proposed that *"the most appropriate approach would be to apply a spread for UK BBB+ and BBB bonds to 5 year Government gilts."*⁹⁴
- 3.43 AlixPartners said that interest should be compounded at yearly intervals.⁹⁵ They further argued that we should consider that the overcharges occurred at the mid-point of the financial year (i.e. 30 September), as this is consistent with the fact that Ethernet services were purchased throughout each of the overcharge years.⁹⁶
- 3.44 In the Second Alix Report, AlixPartners argued that the *"mid-point for each financial year is a reasonable assumption to take for the purpose of this calculation, since this assumes that Ethernet services are purchased and paid for throughout each financial year. BT's argument that the end-of-year should be assumed because an overcharge is only crystallised at the end of each financial year is not consistent with the evidence presented by Ofcom in the Ethernet Final Determination which suggests that Ethernet services are in fact paid for over the course of the year."*⁹⁷

⁸⁸ Alix Report, 2 February 2015, paragraph 3.3.6.

⁸⁹ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015, paragraph 15.2(d), Towerhouse submission on behalf of Vodafone, Virgin and Verizon, 2 February 2015, paragraphs 4.5 and 4.6.

⁹⁰ Alix Report, 2 February 2015, paragraph 4.2.22.

⁹¹ Alix Report, 2 February 2015, paragraph 4.2.19.

⁹² Alix Report, 2 February 2015, paragraph 4.2.20

⁹³ In the Gamma Determination, we said that *"in addition to a risk-free rate for an appropriate term of debt, a spread which estimates the additional risk of investing in BT should be added to the interest rate."* See the Gamma Determination, paragraph 3.93.

⁹⁴ Alix Report, 2 February 2015, paragraph A4.28.

⁹⁵ Alix Report, 2 February 2015, paragraph 5.3.2.

⁹⁶ Alix Report, 2 February 2015, paragraph 6.2.1.

⁹⁷ Second Alix Report, 16 March 2015, paragraph 2.210.

Our analysis

Ofcom's objectives in awarding interest

- 3.45 We explained in the Interest Guidance that:
- 3.45.1 when exercising our powers under section 190(2)(d) of the 2003 Act to make a direction requiring a repayment to be made in the context of resolving a dispute, Ofcom will decide whether interest should be payable, and, if so at what rate, taking account of all relevant considerations, with a view to setting an amount of principal plus interest which would best meet our statutory duties and regulatory objectives, in particular, with a main objective of avoiding CPs having incentives to set unduly high charges;⁹⁸
 - 3.45.2 it is likely to be appropriate to award interest in the majority of cases in which a direction for repayment is considered appropriate in order to avoid creating an incentive for CPs to set charges that are unduly high;⁹⁹ and
 - 3.45.3 our starting point was that the interest rate should generally reflect the time value of the principal to the overcharging firm, i.e. the benefit the overcharging firm enjoys by virtue of the delay between its overcharging and the date on which it makes a repayment.¹⁰⁰
- 3.46 We also said that when awarding interest in disputes, we are likely to consider whether any contractual rate in place would meet our regulatory objectives.¹⁰¹
- 3.47 We noted that, in the Judgment, the CAT considered that our starting point to approaching the award of interest as set out in the Interest Guidance, with reference to our main objective of avoiding an incentive for CPs to set charges that are unduly high, was “*relevant and amply justified on the facts of the present case*”.¹⁰²
- 3.48 The CAT also found that, insofar as the contractual clause precluding interest¹⁰³ is inconsistent with the achievement of our objectives in the circumstances of this case, our decision on interest is not constrained by the contractual provision.¹⁰⁴ The CAT concluded that “*the incentives on BT [to comply with its cost orientation obligation]... were inadequate in this case*” and “*the additional incentive to avoid overcharging that an award of interest provides is entirely appropriate*”.¹⁰⁵ It therefore found that the Ethernet Determinations should have included a direction to pay interest.¹⁰⁶
- 3.49 In line with the Interest Guidance and the views of the Parties in this case, and consistent with the Judgment, our provisional view was that the main objective set out in the Interest Guidance was the appropriate starting point for determining an appropriate rate of interest in this case. We therefore sought to determine a rate of interest in this case which would meet our main objective of avoiding an incentive for

⁹⁸ Gamma Determination, paragraph A2.1.

⁹⁹ Gamma Determination, paragraph A2.3.

¹⁰⁰ Gamma Determination, paragraph A2.4.

¹⁰¹ Gamma Determination, paragraphs A2.5; our regulatory objectives in awarding interest are set out Gamma Determination, paragraph 3.15.

¹⁰² The Judgment, paragraph 314.

¹⁰³ I.e. clause 12.3 of the relevant Ethernet services contracts which provided that interest would not be payable on charges that were recalculated or adjusted under a direction by Ofcom.

¹⁰⁴ The Judgment, paragraph 302.

¹⁰⁵ The Judgment, paragraph 304.

¹⁰⁶ The Judgment, paragraph 315.

CPs to set unduly high charges. We proposed to do so by seeking to determine a rate which would generally reflect the time value of the principal (i.e. the overcharge) to the overcharging firm – in this case BT.

The contractual rate

3.50 We considered that, as the relevant contractual clause relating to the payment of interest in this case does not allow for the payment of interest, awarding interest in line with the contractual rate would not meet our regulatory objectives, as set out in the Judgment. Our provisional view was therefore that it would not be appropriate to award the contractual interest rate in this case.

The approach towards setting an interest rate that reflects the time value of the overcharge

- 3.51 Taking the main objective of the Interest Guidance as our starting point, we considered what rate of interest would best reflect the opportunity cost to the overcharging firm in this case.
- 3.52 In considering the rate of interest that would best reflect the opportunity cost to the overcharging firm, we said that it was relevant to consider whether we are concerned with incentives on the firm, i.e. BT as a corporate entity, or incentives on the owners of the firm, i.e. BT's shareholders.
- 3.53 We noted that, in charge controls we are typically concerned with BT as a corporate entity. This is because it is the firm that needs to raise funds from debt and equity holders for the purposes of investing in the business. We therefore allow the firm a return on its WACC in charge controls.
- 3.54 In provisionally setting the interest rate as part of this dispute, we were concerned with avoiding giving BT an incentive to overcharge. If BT overcharges then any benefit from avoiding interest payments when repaying that overcharge accrues to its shareholders, via lower interest payments and higher profits. Assuming the firm does not default, debt holders have a passive position and receive the same returns regardless of whether BT overcharges or not. Our provisional view was therefore that, since the benefits of overcharging accrue to shareholders, we should consider the incentives on BT's shareholders.
- 3.55 We did not agree with the Disputing Parties that the overcharge should be characterised as reducing BT's net financing requirement. For example, if BT requires £1000 to finance a project, and overcharges CPs by £200, the £200 overcharge does not change the fact that BT's financing requirement for the project is £1000.
- 3.56 Our provisional view was that the overcharge should instead be characterised as an additional source of funding to BT. Given this, we said that the relevant consideration when determining what rate reflects the time value of the overcharge to BT was what sort of funding the overcharge represents. We considered this could be informed by considering the relationship between BT and the Disputing Parties.
- 3.57 We considered that regardless of what any of the parties thought at the time of the overcharge, the overcharge is akin to debt because it represents a sum of money that, consequent on Ofcom's determination that it is an overcharge in breach of BT's regulatory obligations and should be repaid, must be repaid in full. The amount that BT has to repay the Disputing Parties is the same regardless of BT's performance.

- 3.58 We did not consider that the overcharge is akin to equity, because the overcharge has not led to the creation of an additional shareholder who is bearing any equity risk.
- 3.59 With respect to the overcharge, the Disputing Parties did not take on any of the equity risk associated with BT. All equity risk remained with BT's shareholders, as the overcharge has to be repaid in full regardless of BT's performance.
- 3.60 Given that the Disputing Parties did not take on any of the equity risk associated with BT, we disagreed that it would be appropriate to base the interest rate on BT's WACC (which represents the weighted average of BT's cost of debt and its cost of equity).
- 3.61 Our provisional view was therefore that it would be reasonable to expect the opportunity cost to BT of having the benefit of the overcharge over a period of time would reflect its cost of debt. This was because where a debt carries zero interest, as was the case with the overcharge, the benefit to BT's shareholders is the interest rate that would have otherwise been paid on debt.
- 3.62 In line with our reasoning in the Gamma Determination and the Interest Guidance, our provisional view was that it was reasonable to expect that an interest rate based on cost of debt best reflects the time value of the overcharge to the overcharging party.

Whether BoE+1% is an appropriate proxy for BT's cost of debt in this case for the period 2006 to 2012

- 3.63 In the Gamma Determination, we said that we did not consider that it would be appropriate to work out the actual benefit obtained from an overcharge on a case-by-case basis. This was because seeking to assess the actual benefit derived from the overcharge is complex, involving a range of factors and considerations. These factors included:
- 3.63.1 what the overcharging CP actually did or had the reasonable opportunity to do with the overcharge;
 - 3.63.2 the period over which the overcharge occurred;
 - 3.63.3 the date on which the dispute was raised;
 - 3.63.4 the investment/funding conditions available to the overcharging CP over the period; and
 - 3.63.5 the extent of the overcharge.¹⁰⁷
- 3.64 Instead, we said that the principle should be to consider what an overcharging CP would have had a reasonable opportunity to do with those funds and to adopt an interest rate which provides a fair and reasonable proxy for the benefit that the overcharging CP could reasonably have been expected to receive from the funds on that basis.¹⁰⁸ Our provisional view was that it was reasonable and proportionate to adopt a more pragmatic approach, provided that the applicable rate would be within

¹⁰⁷ Some factors that could be relevant in seeking to assess the actual benefit to the overcharging firm are set out at paragraph 3.76 of the Gamma Determination.

¹⁰⁸ Gamma Determination, paragraph 3.79.

the range of the cost of debt to the overcharging CP that may reasonably be expected.

- 3.65 In the Interest Guidance we said that BoE+1% is likely to provide a reasonable approximation of the cost of debt for an overcharging CP such as BT. We recognised, however, that it may be appropriate to depart from that rate where supported by evidence, i.e. where the parties to a dispute put forward reasoned and evidence-based submissions as to why they considered that the BoE+1% would not be appropriate in the circumstances of a given dispute, for example, because it would not meet our regulatory objectives or would be unfair to one of the parties. We explained that this pragmatic approach should help promote regulatory and commercial certainty, whilst providing sufficient flexibility to ensure that the level of interest awarded in a given case achieves our regulatory objectives and is fair as between the parties.¹⁰⁹
- 3.66 The Disputing Parties contended that the Gamma Determination can be distinguished because, in that case, we were concerned with developing a ‘broad-brush’ approach to awarding interest on a forward-looking basis when resolving disputes relating to BT’s Standard Interconnect Agreement, whereas here we are considering the appropriate rate of interest to apply in a specific case of historic overcharging by BT in breach of an SMP condition.¹¹⁰ The Disputing Parties argued that given the overcharging in this case took place over many years and BT did not recognise that it was overcharging at the time, this is a reason to distinguish the Gamma Determination. The Disputing Parties considered that adopting a more “*tailored approach with proper regard to the particular circumstances of BT*” is appropriate, as this would best give effect to Ofcom’s main objective and it would not be unduly burdensome to do so in this particular case.¹¹¹
- 3.67 We noted in the Gamma Determination that “*in principle, the guidance we have outlined as to the appropriate approach to interest in the context of this Dispute may also be relevant more generally to repayments directed by Ofcom relating to other products and services*”.¹¹² We considered that the approach we adopted in the Interest Guidance was an appropriate starting point for our analysis in this case. In the Gamma Determination, we considered the approach to determining an appropriate level of interest when directing the repayment of an overcharge under section 190(2)(d) of the 2003 Act in resolving a dispute. Our provisional view was that that was also the question which we are considering in this case. In both cases, our main objective is the same— i.e. to seek to determine a rate of interest which will reflect the time value of the overcharge to the overcharging CP, in order to avoid creating an incentive to overcharge. Therefore, we did not consider that it was necessary to adopt a more “bespoke” approach because this case concerns a specific incident of historic overcharging, in particular since the approach we outlined in the Interest Guidance already builds in sufficient flexibility to take account of the circumstances of a particular case.
- 3.68 Our provisional view remained that BoE+1%, which has conventionally been adopted by the High Court in commercial cases and by the CAT when awarding interest on

¹⁰⁹ Gamma Determination, paragraphs A2.12 to A2.14.

¹¹⁰ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015, paragraph 15.1, Towerhouse submission on behalf of Vodafone, Virgin and Verizon, 2 February 2015, paragraph 4.3

¹¹¹ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015, paragraphs 15.1 (d) and 22.4 (ii), Towerhouse submission on behalf of Vodafone, Virgin and Verizon, 2 February 2015, paragraph 6-7

¹¹² Gamma Determination, paragraph 4.14.

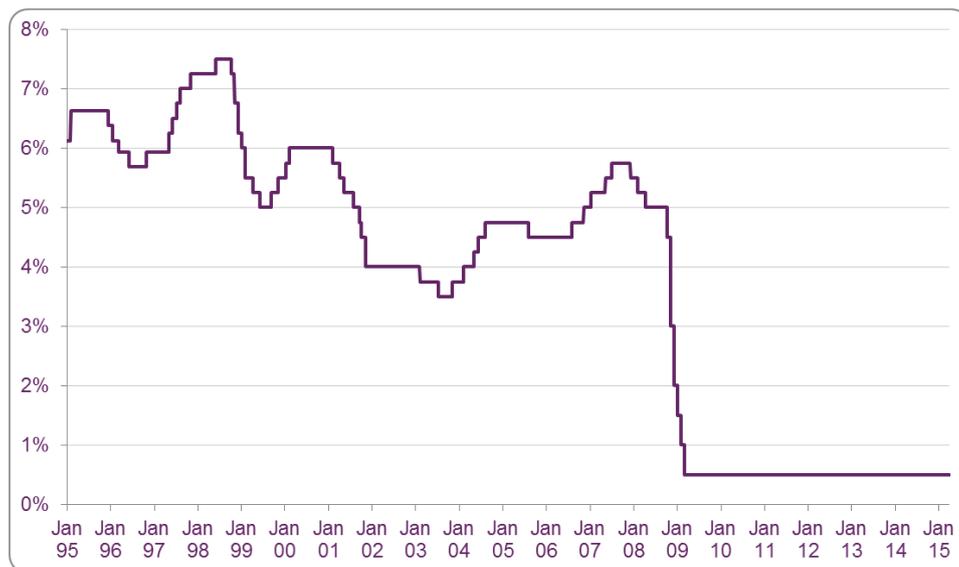
penalties on appeal, was likely to be an appropriate rate to reflect the benefit derived by the overcharging firm from the overcharge in most cases.

- 3.69 However, as set out in the Gamma Determination and in the Interest Guidance, we recognised that it may be appropriate to depart from this rate in order to ensure that our objectives are met, depending on the facts of a particular case. In the circumstances of this case, the Disputing Parties put forward arguments and evidence which they consider supports the view that the BoE+1% would not be an appropriate rate of interest to meet our regulatory objectives on the facts of this case. We therefore considered, in the light of the facts of this case, whether there were grounds to depart from BoE+1% because it would not meet our regulatory objectives in the circumstances and an alternative interest rate would be more appropriate in order to meet our regulatory objectives. Our provisional view was that it was appropriate to do this by cross-checking whether BoE+1% lies outside the range of the cost of debt to BT that may reasonably be expected in the circumstances of this dispute, having regard to the range of periods over which BT could reasonably be expected to retain the overcharge.
- 3.70 In order to carry out this cross check we considered the range of the cost of debt to BT by taking into account:
- The term of the debt, informed by the period over which BT could have reasonably expected to retain the overcharge.
 - The yield on BBB bonds with the same term in the relevant period for the rate of interest on the principal of 2006 to 2012.
- 3.71 We noted that in the Gamma Determination we said that the overcharging party could generally reasonably expect to retain an overcharge for between one year and at least three years.¹¹³ To reflect the fact that in this dispute the period between the start of overcharging and repayment (i.e. 2006 to 2012) was longer than three years, we considered periods of up to five years in our cross check.
- 3.72 We considered the yield on Bloomberg indices of BBB bonds maturing in one to five years compared to the BoE rate during the period 2006 to 2012, which is the period during which BT held the overcharge. Our provisional view was that yields on BBB bonds provide a reasonable estimate of BT's cost of debt because BT was BBB rated throughout this period.¹¹⁴
- 3.73 We noted in this regard that much of the period from 2006 to 2012 coincided with the financial crisis that resulted in significant movements in interest rates, including a number of sharp reductions in the BoE rate in late 2008, as illustrated in Figure 3.1.

¹¹³ Gamma Determination, paragraph 3.126.

¹¹⁴ S&P and Fitch have given BT a BBB +/- rating since mid-2006. Moody's have given BT a Baa1/2 rating since 2001. The Bloomberg Composite rating of these three credit rating agencies is currently BBB.

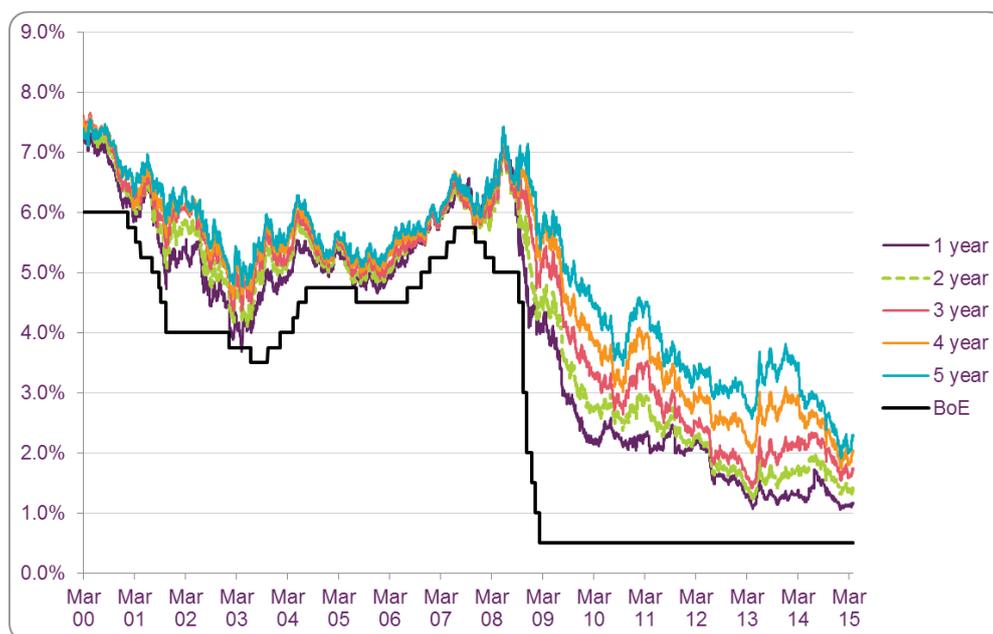
Figure 3.1: Bank of England rate



Source: Ofcom, Bank of England

3.74 Figure 3.2 shows the yield on Bloomberg indices of BBB bonds maturing in one to five years compared to the BoE rate.

Figure 3.2: Yields on BBB bonds compared to BoE rate

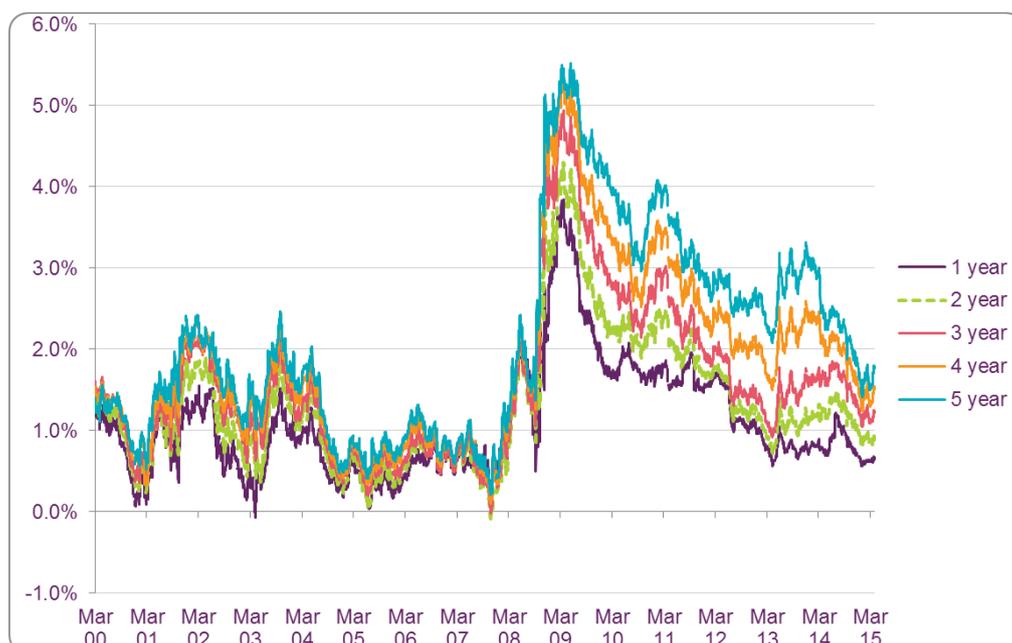


Source: Bank of England, Bloomberg. BBB bonds from Bloomberg using following indices: C4051Y, C4052Y, C4053Y, C4054Y, C4055Y.

3.75 Figure 3.2 indicates that prior to mid-2008 there was a reasonably stable relationship between the BoE rate and yields on BBB bonds maturing in one to five years. Since mid-2008, that relationship has been less stable. The premium of BBB bonds over the BoE rate was particularly volatile during the 2006 to 2012 period, with the premium ranging from 0% to 5.5% above the BoE rate for bonds maturing in one to

five years. This is illustrated in Figure 3.3 which plots the difference between the yields on BBB bonds and the BoE rate.

Figure 3.3: Difference between yields on BBB bonds and the BoE rate



Source: Ofcom, Bank of England, Bloomberg. BBB bonds from Bloomberg using following indices: C4051Y, C4052Y, C4053Y, C4054Y, C4055Y.

3.76 Our provisional view was that this evidence demonstrated that during the 2006 to 2012 period, there was not a stable relationship between the BoE rate and yields on BBB bonds for one to five year terms (as a proxy for BT’s cost of debt). Therefore our provisional view was that adopting a rate of BoE+1% would not, in the particular circumstances of this case, provide a reasonable and appropriate estimate of the cost of BT’s debt during the period 2006 to 2012, regardless of the assumptions made as to the appropriate ‘term’ of the debt (i.e. the period for which BT may reasonably have been expected to hold the benefit of the overcharge).

The appropriate approach to calculating a proxy for BT’s cost of debt in this case

3.77 In light of our provisional conclusion that BoE+1% is not likely to provide a reasonable estimate of the benefit to BT of retaining the overcharge in the circumstances of this case, we considered an alternative approach to calculating an interest rate which would be appropriate to reflect the benefit to BT of holding the overcharge during this period. For the reasons explained at paragraphs 3.51-3.62, our provisional view was that this would be a rate reflecting BT’s cost of debt.

Initial considerations

3.78 In order to calculate an interest rate which would represent BT’s cost of debt we considered that we needed to make assumptions about the following factors, which we discuss further below:

3.78.1 **Point of overcharging and compounding.** In order to estimate an interest rate we need to establish at what point during the relevant financial year the

overcharge is assumed to have occurred. We also need to decide at what intervals interest should be compounded.

3.78.2 Term of the debt on the principal overcharge.

3.78.3 Yield on debt associated with the relevant term.

Point of overcharging and compounding

3.79 We did not agree with BT that it would be reasonable to assume that the overcharge occurs on the final day of each financial year. Although information on BT's revenue and costs for the year is reported as at 31 March, BT generates revenue and incurs costs throughout the financial year. This means that the benefit of any overcharge would also accrue over the course of the financial year.

3.80 We agreed with BT that it is difficult to make assumptions about exactly how the overcharge is spread throughout the year.¹¹⁵ Given this, we also agreed with AlixPartners that it is reasonable to assume that the overcharge occurred at the mid-point of the financial year.

3.81 As to compounding, we noted in the Gamma Determination that conceptually the interest rate should be applied on a compound basis in order to reflect the time value of the extra funds from overcharging to the overcharging firm, as opposed to awarding simple interest.¹¹⁶ We agreed with BT and the Disputing Parties that interest should be compounded annually.

3.82 We therefore provisionally concluded that:

3.82.1 we should assume that the overcharge occurs on 1 October each year, e.g. the overcharge relating to the 2006/07 financial year occurred on 1 October 2006 and on 30 September 2007 it attracted a year's worth of interest; and

3.82.2 interest should be compounded annually.

'Term of debt' on the principal overcharge

3.83 We then considered what would be an appropriate 'term of debt' in respect of the principal overcharge in this case. Following the approach in the Interest Guidance, in the following section we considered the range of periods over which BT could reasonably have been expected to retain the overcharge in this case.

3.84 In line with our views in the Gamma Determination,¹¹⁷ we were of the view that there are a number of factors which could be relevant in determining BT's reasonable expectation of the period it would retain the principal in this case:

- An overcharging firm may reasonably have expected to repay before the actual date of repayment (in this case 28 December 2012).
- An overcharging firm is likely to reasonably have expected to hold on to the overcharge for at least 12 months from the date of overcharge, given (i) the lag between an overcharge occurring and the RFS being published, (ii) a period of

¹¹⁶ Gamma Determination, paragraph 4.74.

¹¹⁷ Gamma Determination, paragraphs 3.124 to 3.126.

negotiation between the overcharging firm and the overcharged firm and (iii) a period of at least four months to resolve the dispute.

- Once a dispute has been accepted by Ofcom, an overcharging firm could generally expect to have to repay within four months. Although disputes have taken longer than this where exceptional circumstances have arisen, it would not be reasonable to assume in general that exceptional circumstances would apply.
- The interest rate should reflect the average rate in effect over the period that the overcharge was retained.

3.85 Our starting point was to consider the actual period that BT retained the principal and what this implies about the average duration. We then considered whether BT could have reasonably expected to retain the principal for a shorter period than this.

3.86 In the Ethernet Disputes, we determined that the first year in which BT overcharged the Disputing Parties was 2006/07. The final year of overcharge was 2010/11. Following the Ethernet Determinations, BT repaid the Disputing Parties on 28 December 2012.¹¹⁸

3.87 Assuming, as set out at paragraph 3.80, that each overcharge occurred at the mid-point of each financial year and given that BT repaid the principal sum to the Disputing Parties on 28 December 2012, Table 3.3 sets out the period that BT retained the principal overcharge arising in each financial year. For example BT retained the overcharge occurring on 1 October 2006 (relating to the 2006/07 financial year) for 6.25 years; that is, the period between 1 October 2006 and 28 December 2012.

Table 3.3: Actual period BT retained the overcharge

Year overcharge occurred	Corrected repayment to Disputing Parties £m	Period retained (years)
2006/07	[✂]	6.25
2007/08	[✂]	5.25
2008/09	[✂]	4.24
2009/10	[✂]	3.24
2010/11	[✂]	2.24
Total	94.6	
Weighted average		5.02

Source: Ofcom

¹¹⁸ BT's 19 February 2015 response to Ofcom's Section 191 Notice.

- 3.88 In this case, the weighted average period that BT retained the principal was about five years (weighted by the total repayment due to the Disputing Parties in each year).
- 3.89 Our provisional view was that there are a number of reasons why it may have been reasonable to expect that BT would have retained the overcharge for a shorter time than the actual period of five years (on average).
- 3.90 Typically, a dispute will be resolved within four months of being accepted, except where exceptional circumstances apply. The Initial Disputes were accepted by Ofcom on 13 September 2010, therefore, in practice, the earliest that BT would have been ordered to make repayment would be four months later, i.e. around 13 January 2011. Assuming an anticipated repayment date of 13 January 2011, Table 3.4 shows a weighted average period of around three years.

Table 3.4: Period BT retained overcharge if repayment expected on 13 January 2011

Year overcharge occurred	Corrected repayment to Disputing Parties £m	Period retained (years)
2006/07	[✂]	4.29
2007/08	[✂]	3.29
2008/09	[✂]	2.28
2009/10	[✂]	1.28
2010/11	[✂]	0.20
Total	94.6	
Weighted average		3.06

Source: Ofcom

- 3.91 BT argued that, in considering how long BT may reasonably have expected to have held on to the overcharge for the purposes of determining an interest rate, it is not relevant that exceptional circumstances applied in the Ethernet Disputes, resulting in the disputes taking more than four months to resolve.¹¹⁹
- 3.92 In practice, the Ethernet Disputes were not resolved within four months as a result of exceptional circumstances. At the time when Ofcom accepted the Initial Disputes for resolution, the CAT was in the process of hearing appeals¹²⁰ against Ofcom's determination of disputes concerning BT's compliance with a similarly-worded cost-orientation obligation relating to Partial Private Circuits (the "PPC disputes")¹²¹. On 5

¹¹⁹ BT submission, 18 March 2015, paragraph 45.

¹²⁰ See <http://www.catribunal.org.uk/237-5136/1146-3-3-09-British-Telecommunications-Plc-.html>

¹²¹ See http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/closed-cases/all-closed-cases/cw_992/ and http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/closed-cases/all-closed-cases/cw_01002/

October 2010, Ofcom announced that it considered that there were exceptional circumstances in the Ethernet Disputes, as there was a significant overlap between the issues raised in the PPC and Ethernet disputes and the judgment in the PPC appeals was likely to have a bearing on the Ethernet Disputes.¹²² Judgment in the PPC appeals was handed down on 22 March 2011, and there was then a further appeal to the Court of Appeal, in which judgment was handed down on 27 July 2012.

3.93 We noted that BT itself appeared to consider that the overlap between the PPC disputes and the Ethernet Disputes meant that there were exceptional circumstances as to why the Ethernet Disputes could not be resolved within the four month statutory period.

3.93.1 After Ofcom opened an enquiry into the Sky & TalkTalk Dispute, BT wrote to Ofcom on 10 August 2010 to say that “*Ofcom should, pending the publication of the PPC Appeal Judgment, find that the PPC Appeal cross-over issues are such that it is appropriate for Ofcom to find that there are exceptional reasons for not proceeding to investigate the dispute at this stage, even though this would result in Ofcom not being able to resolve the dispute within 4 months*”.¹²³

3.93.2 Ofcom wrote to the parties on 13 September 2010, informing them of our decision to accept the Initial Disputes for resolution. We sought the Parties’ views as to whether exceptional circumstances applied in this case. In its response, dated 20 September 2010, BT said that “*There are clearly good reasons in this case to delay the resolution of these Ethernet disputes as the issues clearly overlap with issues in the PPC appeal.*”¹²⁴

3.94 We also noted that on 15 November 2010, BT appealed Ofcom’s decision to accept the Initial Disputes to the CAT. The CAT issued its judgment on 3 May 2011, unanimously dismissing BT’s appeal. Our view was that it was reasonable to assume that BT could have expected that this appeal would have resulted in a delay in the resolution of the Ethernet Disputes.

3.95 While in the Interest Guidance we said that “*it would not be reasonable to assume that in general an overcharging firm could expect that exceptional circumstances would apply*”,¹²⁵ we considered that in the circumstances of this case it may have been reasonable for BT to expect that it may take longer to resolve the Ethernet Disputes than the statutory four month period, as a result of the exceptional circumstances which applied in this case. We thought that it was relevant to take this into account when deciding how long BT could reasonably have been expected to retain the overcharge. However, we were of the view that it is difficult to estimate the length of delay that could have reasonably have been expected.

3.96 On this basis, our provisional view was that it would be appropriate to consider a range of between three and five years on average to represent the period for which BT may reasonably have expected to retain the overcharge in this case. Three years would be the lower bound, which would end four months after Ofcom accepted the Initial Disputes for resolution, and five years would be the upper bound, representing

¹²² See http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/closed-cases/all-closed-cases/cw_01052/

¹²³ Letter from BT to Ofcom, 10 August 2010.

¹²⁴ Letter from BT to Ofcom, 20 September 2010.

¹²⁵ Gamma Determination, paragraph 3.126(b).

the actual period that BT retained the principal. Within this range we proposed to use a central estimate of four years.

Yield on debt associated with the relevant term

- 3.97 We discuss below our provisional estimate of BT's cost of debt for three, four and five year terms in each year starting 1 October between 2006 and 2012.
- 3.98 In the Interest Guidance, we said that the cost of debt to the overcharging firm could be determined by the premium over and above the risk free rate which reflects the risk of default by the overcharging firm.¹²⁶ However, where it is possible to estimate yields on BT's debt with an appropriate term (or yields on debt similar to BT's) during this period, we considered that it was reasonable to estimate the cost of debt by reference to these yields rather than separately identify a risk free rate and a debt premium.¹²⁷
- 3.99 Our starting point in estimating BT's cost of debt in this case was therefore to look at the yields on bonds issued by BT. However, BT's bonds during this period are denominated in a number of currencies (pound sterling, US dollars, euros¹²⁸) and do not mature in exactly three, four or five years as at the midpoint of each financial year. In order to estimate BT's cost of debt for three, four and five year maturities during the period of the overcharge using BT's existing bonds, we would need to:
- a) estimate the average yield of BT's existing bonds for each year starting 1 October;
 - b) translate the yields into sterling using spot and forward currency rates; and
 - c) identify bonds in each year that mature in approximately three, four and five years and estimate by interpolation a sterling yield for the relevant term.
- 3.100 We considered that a range of assumptions would have to be made in order to achieve steps b) and c). Those assumptions would involve first, deciding over what period to estimate spot and forward exchange rates to translate yields to sterling; and second, which BT bonds to use as proxies for the term of the debt and how best to interpolate between two or more bonds where the maturity of BT's bonds does not equate to a three, four or five year term. There may be a range of different reasonable assumptions that could be made in respect of each of these aspects, all of which could lead to a different overall interest rate. Our provisional view was therefore that this approach risked introducing an undesirable level of complexity into the relevant calculation.

¹²⁶ Gamma Determination, paragraph A2.8(b).

¹²⁷ For example, where the debt premium is based on the spread between the yield on BBB bonds of an appropriate maturity and the yield on index linked gilts (as a proxy for the risk free rate) of the same maturity, adding this spread to the yield on index-linked gilts will give the yield on BBB bonds that we started with.

¹²⁸ Table A3.1 of the Alix Report lists the 23 BT bonds that were in issue during the period. Six of these were denominated in euros, seven in sterling and ten in US dollars.

3.101 We provisionally concluded that it would be simpler and more practicable to estimate BT's cost of debt using yields on an index of BBB bonds from Bloomberg.¹²⁹

3.102 During the period 2006-2012, BT was BBB rated.¹³⁰ We said that we would expect the yields on an index of BBB bonds to be a reasonable proxy of BT's cost of debt during this period. Bloomberg has a series of BBB indices covering the 2006-2012 period that are available in a range of maturities, including three, four and five year terms. Figure 3.4 illustrates the yields on these Bloomberg BBB indices.

Figure 3.4: Yields on Bloomberg BBB indices



Source: Bloomberg. C4053Y, C4054Y and C4055Y indices.

3.103 Table 3.5 shows the annual average yields we have estimated using the yields on Bloomberg's BBB indices during the period 2006 to 2012. For each term, the interest rate represents the simple average yield in the period between 1 October and 30 September.

¹²⁹ The use of BBB bonds is consistent with the Gamma Determination. In Table 1 of the Gamma Determination we estimated the debt premium associated with debt maturing in one to four years by reference to the spread of BBB bonds over gilts using data from Bloomberg.

¹³⁰ S&P and Fitch have given BT a BBB +/- rating since mid-2006. Moody's have given BT a Baa1/2 rating since 2001. The Bloomberg Composite rating of these three credit rating agencies is currently BBB.

Table 3.5: Annual yields on Bloomberg BBB indices

Financial year	Year from	3 years	4 years	5 years
2006/07	01 Oct 06	6.0%	6.1%	6.1%
2007/08	01 Oct 07	6.3%	6.4%	6.5%
2008/09	01 Oct 08	5.3%	5.7%	6.0%
2009/10	01 Oct 09	3.4%	3.9%	4.4%
2010/11	01 Oct 10	3.1%	3.6%	4.0%
2011/12	01 Oct 11	2.4%	2.9%	3.3%
2012/13	01 Oct 12	1.8%	2.5%	3.1%

Source: Bloomberg. C4053Y, C4054Y and C4055Y indices. Annual yields are calculated as the simple average of daily yields, where we assume the yield associated with non-trading days is the same as the yield on the last trading day.

3.104 As set out at paragraph 3.96, our provisional view was that BT may have reasonably expected to retain the principal for a period of between three and five years, with a central assumption of four years. We therefore provisionally concluded that the annual yields on Bloomberg's four year BBB index were an appropriate proxy for BT's cost of debt in this case.

We did not propose to estimate cost of debt using swap rates and credit default swaps

3.105 The Ernst & Young Report estimated BT's cost of debt by considering a swap rate as a proxy for the risk free rate plus a credit risk premium on BT's debt by reference to a CDS spread.¹³¹

3.106 As explained above, where it is possible to estimate yields on BT's debt with an appropriate maturity (or yields on debt similar to BT's such as BBB rated debt) our provisional view was that it was reasonable to estimate the cost of debt by reference to these yields rather than separately estimating a risk free rate and a debt premium, as would be the case if we adopted Ernst & Young's proposed approach. In this case, we considered that we could estimate the yields on BBB-rated bonds with appropriate maturities which we considered would be likely to provide a reasonable estimate of BT's cost of debt in this period since BT's debt was BBB-rated throughout the period.

We did not propose to estimate the benefit to BT using interest earned on cash deposits

3.107 BT suggested that the benefit it derived was equal to the interest earned on cash deposits. We disagreed that this would be the relevant interest rate in this case because we considered that BT could have reasonably expected to retain the overcharge for between three and five years and because it had outstanding debt that it could have reasonably repaid in full or in part. We considered that the cash deposit rate would only be appropriate where BT expected to have to repay the

¹³¹ Ernst & Young Report, paragraphs 3.20-3.21.

overcharge within a short period of time such that it would not be practicable to repay debt or where it had no opportunity to repay debt or avoid taking out additional debt (this might be the case, for example, if it had little debt in issue). We did not consider that these factors applied to this case.

Provisional conclusions on the correct rate of interest on the overcharge

3.108 We provisionally concluded that the appropriate rate of interest in the circumstances of this case would be equivalent to the average annual yield on Bloomberg’s BBB bonds with a four year term.

Table 3.6: Annual interest rates on the principal overcharge

Period	Interest rate
01 Oct 06 – 30 Sep 07	6.1%
01 Oct 07 – 30 Sep 08	6.4%
01 Oct 08 – 30 Sep 09	5.7%
01 Oct 09 – 30 Sep 10	3.9%
01 Oct 10 – 30 Sep 11	3.6%
01 Oct 11 – 30 Sep 12	2.9%
01 Oct 12 – 28 Dec 12	2.5%

Source: Ofcom

Interest on Interest

Introduction

3.109 The Disputing Parties argued that BT should also be required to pay interest on the unpaid interest. This would mean that BT would have to pay interest on the principal overcharge up to the date that it repaid the Disputing CPs following the Ethernet Determinations (28 December 2012), and then interest on unpaid interest thereafter.

3.110 We therefore also considered whether BT should pay the Disputing CPs interest on the unpaid interest from after the date it repaid the Disputing CPs following the Ethernet Determinations, and, having decided that this was appropriate, the appropriate rate of interest.

Whether BT should be required to pay ‘interest on interest’

Parties’ views

3.111 As noted above, the Disputing Parties argued that Ofcom needs to reflect the fact that interest was not paid by BT to them at the date of the Ethernet Determinations and still has not been paid, and BT should be required to pay them a sum of money in respect of that unpaid interest.

3.112 The Alix Report stated:

“From an economic perspective, there is no question that BT has gained a benefit associated with the delayed repayment of the interest on overcharges. Had the earlier repayment been designed to meet Ofcom’s objective of ensuring BT did not have an incentive to set excessive charges (and hence the benefit of the overcharge to BT been fully paid) it would have paid both the principal and a sum reflecting the interest on the overcharge up to the date of repayment. Since the interest component was not repaid alongside the repayment of principal, BT has gained the advantage of holding this interest for the period.”¹³²

3.113 Sky and TalkTalk said that BT should have to pay interest on interest because “*full disgorgement is important in giving effect to Ofcom’s statutory objectives.*”¹³³ They observed that “*more than two years have passed in which BT has been able to reap the benefit of (wrongly) retaining this money*” and that unless interest on interest is paid “*BT will be better off as a result of having overcharge than if it had complied with its regulatory obligations.*”¹³⁴

3.114 Sky and TalkTalk compared the payment of interest on interest to BT’s position that it should be awarded interest on the ECCs adjustment. They said that “*the basis for BT’s position is that the CPs ‘have had the benefit’ of this amount (BT §56), and BT considers it to be ‘a matter of principle’ that it should be awarded interest on it. By parity of reasoning, BT should have to pay interest to reflect the period over which it held on to funds to which it was not entitled.*”¹³⁵

3.115 BT argued that Ofcom has no jurisdiction to order BT to pay interest in respect of the unpaid interest (which we will refer to as ‘interest on interest’). BT argued that:

3.115.1 the original dispute submissions “*only requested interest on the principal sum*” and that the scope of the dispute “*did not suggest anything further than a payment in respect of the principal sum overcharged*”;¹³⁶

3.115.2 The Altnets did not seek the specific relief of interest on interest in the Notice of Appeal to the CAT and the CAT only has jurisdiction to determine the appeal in accordance with the Notice of Appeal;¹³⁷ and

3.115.3 The CAT did not address this issue in the Supplementary Judgment (despite the Altnets having specifically raised the issue before the CAT) and the Orders remit to Ofcom only the question of the rate of interest payable in respect of BT’s overcharge for Ethernet services, therefore no issue permitting Ofcom to make such an order has been remitted by the CAT to Ofcom.¹³⁸

¹³² Alix Report, 2 February 2015, paragraph 6.5.2.

¹³³ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 16 March 2015, paragraph 37.

¹³⁴ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 16 March 2015, paragraph 37.

¹³⁵ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 16 March 2015, paragraph 38.

¹³⁶ BT submission, 2 February 2015, paragraph 51; see also BT submission, 18 March 2015, paragraph 73(a).

¹³⁷ BT submission, 2 February 2015, paragraph 52; see also BT submission, 18 March 2015, paragraph 73(b).

¹³⁸ BT submission, 2 February 2015, paragraph 52; see also BT submission, 18 March 2015, paragraph 73(c).

- 3.116 BT said that even if Ofcom were to have jurisdiction to consider this matter, “*Ofcom itself decided to follow the contractual rate of interest (i.e. no interest) in making its original Determination.*”¹³⁹ BT argued that it was entitled to rely on the Determination, and that this has been recognised in previous cases before the CAT, specifically the 08x Numbers case.¹⁴⁰
- 3.117 BT also observed that: “*The Tribunal’s whole basis for allowing the appeal on interest was to provide an incentive to BT not to overcharge. However, for the period after 20 December 2012, the alleged interest (i.e. the interest on interest) arose, not as a result of BT’s overcharging, but as a result of BT following Ofcom’s Determination. The very justification for allowing interest, therefore, simply does not arise with the Altnets’ request for ‘interest on interest.’*”¹⁴¹
- 3.118 In summary, BT said that “*to penalise BT now for following Ofcom’s original decision and not paying interest at the end of 2012, not only sends out a perverse regulatory message (namely that regulated parties cannot rely upon rulings of regulators) but completely subverts the principle upon which both Ofcom in the Gamma Determination and the Tribunal accepted as the reason for awarding interest.*”¹⁴²
- 3.119 Sky and TalkTalk said that their Notice of Appeal and the CAT’s Orders “*are worded sufficiently broadly as to cover the payment of interest to reflect the benefits to BT of holding on to funds until the date of Ofcom’s order for repayment*” and that “*there is nothing in either which precludes an order for interest over that period.*”¹⁴³

Our analysis

- 3.120 The CAT has found that BT should have been ordered to pay interest in respect of the repayment of the overcharge in December 2012. Because BT was not ordered to pay interest on the principal overcharge, we considered that there has been a period over which BT has retained this sum representing the interest payment which should have been made.
- 3.121 While we noted BT’s argument that it was entitled to rely upon Ofcom’s original determination not to pay interest, we also noted that our determination in the Ethernet Disputes of the correct level of interest has since been overturned by the CAT and Ofcom is now bound to give effect to the CAT’s Orders and to determine the rate of interest payable in respect of BT’s overcharge.
- 3.122 The CAT said that “*the facts clearly demonstrate that the incentives on BT [to comply with its cost orientation obligation]... were inadequate in this case, and the additional incentive to avoid overcharging that an award of interest provides is entirely appropriate.*”¹⁴⁴ We were provisionally of the view that, as explained above, and consistent with the Interest Guidance, our main objective in awarding interest is to ensure that CPs do not have an incentive to set charges that are unduly high, and the CAT agreed with this objective.

¹³⁹ BT submission, 2 February 2015, paragraph 53.

¹⁴⁰ BT refers to the 08x Numbers Case [2011] CAT 24, where the CAT held that the Mobile Network Operators should not be penalised for relying on Ofcom’s determination in that case, at paragraph 456(4) of that Judgment.

¹⁴¹ BT submission, 2 February 2015, paragraph 54.

¹⁴² BT submission, 18 March 2015, paragraph 13.

¹⁴³ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 16 March 2015, paragraph 39.

¹⁴⁴ The Judgment, paragraph 304.

- 3.123 Our provisional view was that in all the circumstances of the case it is fair and appropriate for BT to pay an amount representing interest on the unpaid interest since December 2012 to ensure that our main objective is met. We considered that by retaining this sum of money, BT has derived a benefit in much the same way that it would have in the case of an overcharge, for example it could have repaid outstanding debt or avoided taking out debt. Therefore, in order to ensure that the benefit that BT derived from the overcharge is removed, we provisionally concluded that BT should pay interest on interest.
- 3.124 We noted that in the Supplementary Judgment, the CAT did not specifically respond on the point of whether or not the Disputing Parties should be awarded interest in respect of the unpaid interest. However, the CAT ordered Ofcom to determine “*the rate of interest payable in respect of BT’s overcharge for Ethernet services*” and “*the total amount payable as between BT and Sky and TalkTalk*” and “*the total amount payable as between BT and the Altnets.*”¹⁴⁵ Our provisional view was that the wording of the CAT’s Orders was not limited to consideration of interest on the principal overcharge but instead was sufficiently broad to cover the issue of whether a sum should be paid in respect of interest on unpaid interest.

The appropriate proxy for cost of debt during the period of interest on interest

Parties’ views

- 3.125 As noted at paragraphs 3.115-3.118, BT said that it should not be required to pay interest on interest, and made no comment on the appropriate proxy for cost of debt during this period.
- 3.126 AlixPartners argued that “*the most appropriate rate for the period to August 2014 is the WACC, with the conservative approach of applying the cost of debt rate to the remaining period until the interest is repaid*”, although they suggested that the case for applying a WACC rate to the period from December 2012 is less strong than in the case of the earlier period.¹⁴⁶ This is because before the Judgment of the CAT was handed down in August 2014, there would have been a period of uncertainty during which the market would “*not have had any clear information to suggest that interest would be required for a significant period from December 2012.*”¹⁴⁷
- 3.127 AlixPartners said that the relevant rates for this period are the BT Group nominal vanilla WACC and BT’s weighted average cost of debt based on BT’s actual bonds.¹⁴⁸

Our analysis

- 3.128 In line with the approach in the Interest Guidance and as discussed above in relation to the rate of interest on the principal overcharge, we took as our starting point the assumption that BoE+1% is likely to be an appropriate rate to reflect the benefit to BT for having not had to pay interest on the unpaid interest since the date of the Ethernet Determinations, provided that it would be within a reasonable range for BT’s cost of debt during the relevant period. This was because we considered that the nature of the benefit BT has received from not paying interest at the time of the

¹⁴⁵ Order of the CAT, case no. 1206/3/3/13 and Order of the CAT, case no 1207/3/3/13.

¹⁴⁶ Alix Report, 2 February 2015, paragraph 6.5.9.

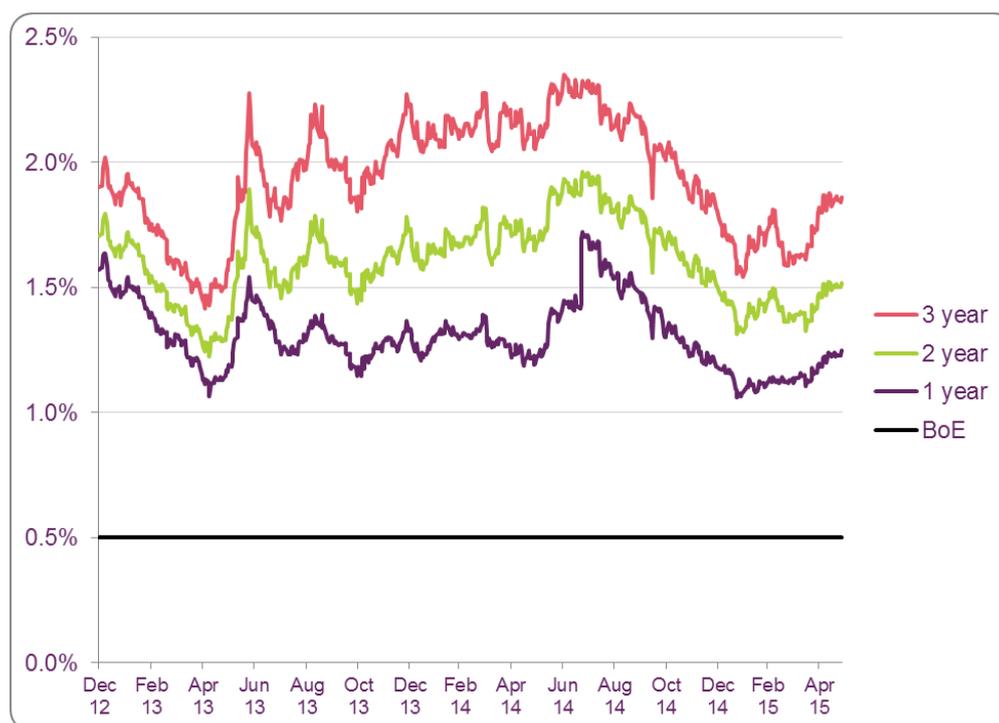
¹⁴⁷ Alix Report, 2 February 2015, paragraph 6.5.7.

¹⁴⁸ Alix Report, 2 February 2015, paragraph 6.5.10.

Ethernet Determinations is comparable to the benefit that BT has derived from the overcharge itself.

- 3.129 As with the interest rate on the principal overcharge, we considered whether there are grounds to depart from BoE+1% because it would not meet our regulatory objectives in the circumstances and an alternative interest rate would be more appropriate in order to meet our regulatory objectives. We considered that it was appropriate to do this by cross-checking whether BoE+1% lies outside the range of the cost of debt to BT that may reasonably be expected in the circumstances of this dispute, having regard to the range of periods over which BT could reasonably be expected to retain the relevant sum of money – in this case, the unpaid interest on the principal.
- 3.130 In making an assumption as to what an appropriate ‘term of debt’ would be for the purposes of this cross-check, we assumed that BT is likely to have retained the interest due on the principal for a total period of around two and a half years (i.e. from 28 December 2012 up until the date of repayment following our final determination of the Remitted Matters).
- 3.131 However, we also considered that there may be reasons why BT may reasonably have been expected to retain the interest on the principal overcharge for a shorter time than two and a half years. We noted, for example, that the oral hearing for the Ethernet appeals concluded at the end of November 2013 and it could have been reasonable to expect that judgment might have been handed down in the case from early 2014 onwards and that a subsequent order to pay interest could have been handed down shortly after that.
- 3.132 Our provisional view was therefore that it would be reasonable to look at a range of between one and two and a half years from 28 December 2012 in undertaking a ‘cross-check’ as to whether BoE+1% would represent a reasonable proxy for BT’s costs of debt in this case.
- 3.133 Unlike the 2006-2012 period associated with the principal overcharge, between late 2012 to date, the BoE rate has been unchanged at 0.5% and there has been a less volatile relationship between the BoE rate and BT’s cost of debt. To illustrate this, Figure 3.5 shows the yield on Bloomberg indices of BBB bonds maturing in one, two and three years compared to the BoE rate, during the period 28 December 2012 to the end of May 2015.

Figure 3.5: Yields on BBB bonds compared to BoE rate



Source: Ofcom, Bloomberg, Bank of England.

- 3.134 During this period, the difference between the yields on one, two and three year BBB bonds and the BoE rate averaged 0.8%, 1.1% and 1.4% respectively.
- 3.135 Our provisional view was that evidence from Figure 3.5 suggests that BoE+1% would be a reasonable proxy for BT's cost of debt for debt with terms of one to 2.5 years during this period. We therefore proposed to estimate interest on unpaid interest using BoE+1%.

Provisional conclusions on interest on interest

- 3.136 We provisionally concluded that in estimating interest on interest the appropriate rate of interest is equivalent to BoE+1%.

Interest on ECCs

Introduction

- 3.137 The CAT found that Ofcom should have accepted BT's argument that the cost of ECCs was already reflected in the financial data it provided for 2009/10 and reflected this in the adjustment it made for BT's ECC costs.
- 3.138 Because Ofcom did not do so, the repayments we ordered BT to make were higher than they would otherwise have been. BT argued that it was entitled to interest on the overpayment that it made to the Disputing CPs as a result of Ofcom's ECCs adjustment.
- 3.139 The CAT ordered us to determine BT's claim for interest in respect of the overpayment resulting from the exclusion of ECCs.

Parties' views

- 3.140 BT argued that it should be awarded interest on the overpayment of the principal overcharge that it made due to ECCs, which has meant that the Disputing Parties were repaid an excess of what they were entitled to. BT argued that it should be entitled to offset interest on this amount against the sum that BT will itself pay in interest for reasons of equity, fairness and good regulatory practice.¹⁴⁹
- 3.141 Sky and TalkTalk accepted that BT, by analogy to the approach on interest on unpaid interest, is entitled to interest on ECCs on the same terms.¹⁵⁰
- 3.142 The Altnets did not comment on this point in their submissions.

Our analysis

- 3.143 Our provisional view was that, in the interests of fairness, it is appropriate for BT to receive interest on ECCs. For the same reason, we considered that the appropriate rate of interest is BoE+1%.

Provisional conclusion on whether to award interest on the ECCs overpayment

- 3.144 We provisionally concluded that BT should be entitled to an amount representing interest on the overpayment due to ECCs at a rate of BoE+1%. By calculating a net amount due to the Disputing Parties, and allowing for interest on that net amount only, BT's entitlement to interest on ECCs was given effect to in the Provisional Conclusions.

The total amounts payable as between BT and each of Sky, TalkTalk, CWW, Virgin and Verizon

Introduction

- 3.145 The CAT ordered us to determine the total amount payable between BT and each of Sky, TalkTalk, CWW, Virgin and Verizon.
- 3.146 We took the following steps to determine this matter:
- a) we calculated the interest BT must pay up to the date that BT originally repaid each CP following the Determinations, taking account of any adjustment to the principal overcharge in relation to BT's ECCs; and
 - b) set out the steps that BT must take to calculate further payments in respect of interest awarded on interest, less any amount that BT is owed in relation to ECCs.

Our analysis

Correction for ECC overpayment and interest on corrected principal

- 3.147 For the period to 28 December 2012 (i.e. the date on which BT made repayments of the principal overcharge as originally calculated by Ofcom in the Ethernet

¹⁴⁹ BT submission, 2 February 2015, paragraph 57.

¹⁵⁰ Herbert Smith Freehills submission on behalf of Sky and TalkTalk, 2 February 2015, paragraph 26.

Determinations), we provisionally concluded that BT should be required to pay interest on the adjusted level of principal overcharge (see paragraph 3.108 above) at the rates set out in Table 3.6.

3.148 We also said that BT should be entitled to a refund as at this date of the overpayments it made in respect of ECCs, as set out in Table 3.2.

3.149 Table 3.7 sets out our provisional assessment of the repayments due from BT to the Disputing Parties, showing separately our provisional view on the interest due from BT as at 28 December 2012 on the adjusted level of the principal overcharge and the repayment due to BT in relation to ECCs. Annex 1¹⁵¹ shows the interest due to the Disputing Parties in each year.

Table 3.7: Interest on the principal overcharge and ECC repayments

	ECC repayment	Interest on corrected principal overcharge to 28 December 2012	Net amount payable from BT to Disputing CPs
Sky	[✂]	[✂]	[✂]
TalkTalk	[✂]	[✂]	[✂]
Virgin	[✂]	[✂]	[✂]
CWW	[✂]	[✂]	[✂]
Verizon	[✂]	[✂]	[✂]
Total	(203,000)	22,422,000	22,219,000

Source: Interest on principal is calculated by applying the interest rates from Table 3.6 to the principal amount from Table 3.1. The ECC repayment is taken from Table 3.2.

Interest on interest and on ECC overpayment

3.150 We were provisionally of the view that BT should be required to make interest payments on the net amount due as at 28 December 2012 from Table 3.7 at an annual rate of BoE+1%. The net amount represented the interest due from BT on the principal overcharge less the repayments due to BT relating to ECCs. Making interest payments on this net amount would mean that the interest rate applicable to both interest on interest and interest on ECCs is BoE+1%.

Provisional conclusion on the total amount payable

3.151 We provisionally concluded that:

- BT should repay a total of £22,219,000 to the Disputing CPs representing the interest due on the principal overcharge as at 28 December 2012, net of any repayments relating to ECCs.

¹⁵¹ In the Provisional Conclusions, this was Annex 3

- BT should pay interest on the amount of £22,219,000 from 29 December 2012 at an annual rate of BoE+1%.

Assessment of consistency of Ofcom’s provisional conclusion with our statutory duties and Community obligations

3.152 As part of our analysis, we also considered our general duties in section 3 of the Act and also the six “Community requirements” set out in section 4 of the 2003 Act, which give effect, among other things, to the requirements of Article 8 of the Framework Directive.¹⁵² In particular, we had regard to:

- a) our duty to further the interests of citizens (i.e. all members of the public in the United Kingdom) in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition (section 3(1));
- b) our duty to have 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 any other principles appearing to Ofcom to represent the best regulatory practice (section 3(3)); and
- c) our duty to promote competition (section 4(3)) and to encourage, to the extent Ofcom considers it appropriate, the provision of network access and service interoperability for the purposes of securing efficiency and sustainable competition in communications markets, efficient investment and innovation and the maximum benefit for the customers of communications network and services providers (sections 4(7) and 4(8)).

3.153 We considered that our provisional conclusions were consistent with these duties for the reasons set out above which are firmly rooted in the duties contained in the 2003 Act.

3.154 In setting out our provisional assessment, we kept in mind our duty under subsection 3(3)(a) of the 2003 Act to ensure that our regulatory activities are, among other things, transparent, accountable, proportionate and targeted only at cases where action is needed. In particular, we noted that the Provisional Conclusions set out the Parties’ arguments and the reasoning that underpinned our provisional assessment, and the Parties would have an opportunity to comment on this in advance of our final determination of the Remitted Matters.

Summary of provisional conclusions

3.155 Based on the analysis set out in this section, the outcome of our provisional assessment in respect of the Remitted Matters was that:

- 3.155.1 Adjusting for the ECC overpayment, the correct amount of principal overcharge by BT should be £94,620,000.
- 3.155.2 The corrected figure above takes account of the repayment that BT should be entitled to in respect of the exclusion of ECCs of £203,000.

¹⁵² Directive 2002/21/EC.

- 3.155.3 The interest on the corrected principal overcharge payable by BT should be £22,422,000.
- 3.155.4 The net amount which BT should repay to the Disputing Parties (i.e. the interest on the corrected principal overcharge less the ECCs adjustment) should be £22,219,000.
- 3.155.5 From 29 December 2012, BT should pay interest on the net amount due to the Disputing Parties at a rate of BoE+1%.
- 3.156 From 29 December 2012, BT should be entitled to interest on the ECC overpayment. By calculating a net amount due to the Disputing Parties, and allowing for interest on that net amount only, BT's entitlement to interest on the ECC overpayment at a rate of BoE+1% would be given effect to.

Section 4

Analysis and final conclusions

Introduction

- 4.1 We received three responses to our Provisional Conclusions. BT, Towerhouse (on behalf of the Altnets) and Herbert Smith Freehills (on behalf of Sky and TalkTalk) each provided a response. The Disputing Parties also provided a joint report by AlixPartners in response to our Provisional Conclusions (the “third Alix Report”).
- 4.2 In this section, we summarise the issues raised in the responses to the Provisional Conclusions and, having considered those responses, we set out our analysis, final conclusions and determinations. The Determinations can be found at Annexes 3 to 7.

The correct level of principal overcharge

Introduction

- 4.3 As explained in paragraph 3.2 of the Provisional Conclusions, we proposed to take account of the repayments for ECCs by adjusting our original calculation of BT’s overcharge to account for ECC costs in 2009/10.
- 4.4 BT provided its calculations of the correct amount of overcharge by BT to Ofcom and the Disputing Parties on 5 September 2014. We provisionally concluded that the repayments should be amended in line with BT’s 5 September 2014 adjustments.

Parties’ views

- 4.5 None of the Parties commented on our provisional conclusions on the corrected total overcharge by BT.

Final conclusions on the correct level of principal overcharge

- 4.6 We remain of the view that the repayments should be amended in line with BT’s 5 September 2014 adjustments. The amounts due to BT in respect of the ECCs adjustment therefore remain as set out in Table 3.2 of the Provisional Conclusions.
- 4.7 We conclude that, taking account of the adjustment in respect of ECCs, the correct amount by which BT overcharged the Disputing Parties is £94,620,000. The amounts which BT should have repaid to the Disputing Parties are as set out in Table 4.1.

Table 4.1 Corrected total overcharge by CP (£)

	2006/07	2007/08	2008/09	2009/10	2010/11	Total
Sky	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
TalkTalk	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Virgin	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
CWW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Verizon	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total CPs	[✂]	[✂]	[✂]	[✂]	[✂]	94,620,000

Source: Email from BT to Ofcom, Towerhouse and Herbert Smith Freehills, 5 September 2014¹⁵³

The appropriate rate of interest on the principal

Introduction

- 4.8 We provisionally concluded that the appropriate rate of interest on the principal in the circumstances of this case is equivalent to the average annual yield on Bloomberg's BBB bonds with a four year term, as set out at paragraph 3.108 of the Provisional Conclusions.
- 4.9 In this section we consider the Parties' views and set out our conclusions under the following headings. These headings are the same as those in the Provisional Conclusions:
- Ofcom's objectives in awarding interest.
 - The approach towards setting an interest rate that reflects the time value of the overcharge.
 - Whether BoE+1% is an appropriate proxy for BT's cost of debt in this case for the period 2006 to 2012.
 - The appropriate approach to calculating a proxy for BT's cost of debt in this case:
 - Point of overcharging and compounding.
 - Term of the debt on the principal overcharge.
 - Yield on debt associated with the relevant term.
 - Conclusion on the correct rate of interest on the overcharge.

¹⁵³ Email from BT to Ofcom, Towerhouse and Herbert Smith Freehills, 5 September 2014

- 4.10 We conclude that the appropriate rate of interest on the principal in the circumstances of this case is equivalent to the average annual yield on Bloomberg's BBB bonds with a four year term.

Ofcom's objectives in awarding interest

Parties' views

- 4.11 The Parties did not make any specific comments on the appropriateness of Ofcom's objectives in awarding interest

Final conclusions on Ofcom's objectives in awarding interest

- 4.12 As set out in the Provisional Conclusions,¹⁵⁴ we remain of the view that, in line with the Interest Guidance and the views of the Parties, and consistent with the Judgment, the main objective set out in the Interest Guidance is the appropriate starting point for determining an appropriate rate of interest in this case. We will therefore seek to determine a rate of interest which meets our main objective of avoiding creating an incentive for CPs to set unduly high charges. We will do so by seeking to determine a rate which would generally reflect the time value of the principal (i.e. the overcharge) to the overcharging firm, in this case BT. This time value of the overcharge derives from BT retaining the overcharge for a period of time by virtue of the delay between its overcharging and the date on which it makes a repayment. For convenience, throughout this section we refer to this as the "benefit of the overcharge".

The approach towards setting an interest rate that reflects the time value of the overcharge

Introduction

- 4.13 In the Provisional Conclusions we said that the overcharge was akin to debt because it represented a sum of money that must be repaid in full. Since repayment of the overcharge did not depend on the performance of the firm (i.e. the Disputing Parties did not take on any of the equity risk associated with BT), we said the overcharge was not akin to equity. We therefore disagreed with the Disputing Parties that it would be appropriate to base the interest rate on BT's WACC, since it represented the weighted average of BT's cost of debt and its cost of equity.¹⁵⁵
- 4.14 We also disagreed with BT that we should estimate the benefit it derived based on the cash deposit rate as we said that this would only be appropriate where BT expected to have to repay the overcharge within a short period of time such that it would not be practicable to repay debt or where it had no opportunity to repay debt or avoid taking out additional debt.

Parties' views

- 4.15 AlixPartners (on behalf of the Disputing Parties) argue that Ofcom was wrong to adopt a cost of debt rather than a WACC-based approach. It makes the following arguments in support of this:

¹⁵⁴ Provisional Conclusions, paragraphs 3.45 to 3.49

¹⁵⁵ Provisional Conclusions, paragraphs 3.51 to 3.62

- a) **Gross financing compared to net financing.** AlixPartners consider that Ofcom’s argument that the overcharge does not reduce BT’s net financing requirement fails to recognise the distinction between gross and net financing. AlixPartners say that while the overcharge would not change the amount of financing a particular project required, the overcharge changed the composition of BT’s balance sheet and reduced the amount of finance it needed to source externally for such a project.¹⁵⁶
- b) **Equity risk arguments are not relevant.** AlixPartners say that the fact that the overcharge has not led to the creation of an additional shareholder which is bearing equity risk is not relevant to the argument in favour of WACC. AlixPartners say that the appropriate rate of interest is not one that reflects the extent of risk borne by the CPs, but rather one that ensures that BT has no incentive to overcharge, and therefore one which reflects the benefit to BT.^{157,158}
- c) **The overcharge does not represent a debt.** AlixPartners do not agree that it is irrelevant what the parties thought at the time of the overcharge or thereafter. They consider that a debt obligation from BT to the CPs would suggest recognition of the overcharge when it occurred and an explicit agreement for the repayment on agreed terms. When the overcharge occurred, there was no recognition that an overcharge had occurred or that it may need to be repaid. They consider that the fact that BT did not book a provision in respect of any potential overcharge repayment in any year prior to 2012/13 suggests that BT did not think that repayment was probable.¹⁵⁹ In addition, AlixPartners say that a number of events need to happen in order for repayment to occur (e.g. a dispute is raised, Ofcom pursues the dispute and finds a overcharge that is upheld on any appeal).¹⁶⁰ AlixPartners also observe that the total industry overcharge might not be repaid in full if some overcharged firms are no longer in the market.
- d) **Gearing effects.** AlixPartners consider that Ofcom’s proposed approach only considered the direct effects of the overcharge and failed to consider the indirect effects, specifically the effect on gearing. AlixPartners say that according to the Modigliani-Miller irrelevance theorem (the “MM irrelevance theorem”), the WACC would remain unchanged when gearing changes, e.g. if a company issued debt, the cost of debt and cost of equity would increase, but the change in gearing would mean the overall WACC was unchanged.¹⁶¹
- e) **Not only BT shareholders will benefit.** AlixPartners say that while BT’s shareholders will have been the main beneficiaries of the overcharge, existing

¹⁵⁶ Third Alix Report, 17 July 2015, paragraph 2.3.2

¹⁵⁷ Third Alix Report, 17 July 2015, paragraphs 2.3.12-2.3.14

¹⁵⁸ The Altnets consider it to be an “*administrative law error*” for Ofcom to take this “irrelevant consideration” into account. See Towerhouse’s response to the Provisional Conclusions on behalf of Vodafone, Virgin and Verizon, 17 July 2015, paragraph 13c.

¹⁵⁹ AlixPartners are referring to BT’s published statutory accounts. The repayment of principal overcharge in the Ethernet Disputes was first recognised in BT’s published statutory accounts in 2012/13 where “*charges of £151m and £36m were recognised against revenue and EBITDA respectively, following Ofcom’s determinations on historic Ethernet pricing*” (note 9, page 121). We note that BT has provided evidence that it made provisions associated with Ethernet services in its 2009/10 statutory accounts (see paragraph 4.74) and we discuss the relevance of this in paragraphs 4.82 to 4.88.

¹⁶⁰ Third Alix Report, 17 July 2015, paragraphs 2.3.6-2.3.10

¹⁶¹ Third Alix Report, 17 July 2015, paragraphs 2.3.3-2.3.5

debt holders will also have gained since the risk of default for them will have been reduced (if only by a small amount).

- 4.16 BT “*endorses and approves Ofcom’s rejection of WACC as having any application to this case*”.¹⁶²
- 4.17 BT says that if Ofcom departs from the Gamma Interest rate then it should take into account BT’s actual use of the overcharge.¹⁶³ BT said that it used the overcharge to help build up a large cash surplus during the relevant period on which it was earning, approximately, the BoE Base Rate.¹⁶⁴ BT says that the scale of its cash deposits during the relevant period meant that it did not need to borrow and the fact that its cash holdings were increasing meant that it was not repaying outstanding debt.¹⁶⁵

Ofcom’s views

- 4.18 In this sub-section, we are concerned with considering the following question: what is the nature of the benefit to BT of the overcharge? In doing so, we are concerned with meeting our main objective of avoiding creating an incentive for CPs to set unduly high charges.
- 4.19 In principle, BT could have used the money made available from the overcharging in a number of ways – for example, it could have paid down debt or avoided taking on additional debt, it could have used the money in place of taking out additional (or reducing existing) equity finance or paying cash dividends, or it could have held it in a low-interest bearing cash deposit account. We are not concerned, however, with specifically seeking to identify what BT in fact did with the funds obtained through overcharging.
- 4.20 Instead we consider that the benefit of the overcharge to BT is represented by the financing opportunities available, and which otherwise would not have been available, as a result of the additional funds from the overcharge during the relevant period. In other words, we are concerned with estimating the rate of interest that would best reflect the opportunity cost to the overcharging firm of having retained the overcharge over the relevant period. This is not necessarily the same thing as what BT actually did with the money.
- 4.21 In the rest of this sub-section we first consider the arguments made by AlixPartners in support of basing the interest rate on BT’s WACC rather than the cost of debt. We then consider BT’s arguments about how it actually used the overcharge.

Benefit to BT should be assessed with reference to the benefit to BT’s shareholders

- 4.22 As noted in the Provisional Conclusions, in considering the rate of interest that would best reflect the opportunity cost to the overcharging firm, it is first relevant to consider whether we are concerned with the incentives of the firm (i.e. BT as a corporate entity), or on the owners of the firm. We remain of the view that the benefits of overcharging primarily accrue to the overcharging firm’s shareholders (through lower

¹⁶² BT’s response to the Provisional Conclusions, 17 July 2015, paragraph 11.

¹⁶³ BT’s response to the Provisional Conclusions, 17 July 2015, paragraph 15.

¹⁶⁴ BT’s response to the Provisional Conclusions, 17 July 2015, paragraph 16

¹⁶⁵ BT’s response to the Provisional Conclusions, 17 July 2015, paragraph 17

interest payments and higher profits), since it is the shareholders who ultimately retain control over the overcharging firm and to whom management is accountable.

- 4.23 We note AlixPartners' argument that there could also be a benefit to the overcharging firm's debtholders.¹⁶⁶ However, we consider that the benefit to debtholders in this case is likely to be small,¹⁶⁷ and in any event debtholders are not the owners of the firm and so we are less concerned with their incentives than the incentives on shareholders. The potential for a benefit to debtholders does not, therefore, change our view that in this case we should assess the benefit to BT's shareholders.

Does the retention of the overcharge affect the net financing requirement?

- 4.24 We consider that the benefit to BT arose from the opportunity to use the overcharge in place of an alternative source of financing that it would otherwise have needed to procure at a cost reflecting the risk associated with that financing.
- 4.25 The Disputing Parties argue that an interest rate based on WACC is the appropriate approach because the overcharge reduces BT's net financing requirement. AlixPartners argue that the overcharge reduced BT's net financing requirement because it changed the composition of BT's balance sheet and reduced the amount of finance that it needed to source externally for any particular project. They argue that, taking into account the principles of corporate finance, the reduction in the funding requirement constitutes a combination of equity as well as debt, and leads to a benefit valued at the WACC.
- 4.26 In this sub section, we first propose a way to establish whether the overcharge should be considered as a reduction in the net financing requirement or a source of finance for the project. We then consider the effect of BT's overcharging in this case against that consideration.
- 4.27 It is useful to start by considering the reason why there is a difference between the cost of debt and the cost of equity (noting that the ungeared cost of equity is also equal to the WACC). If there were no difference between the cost of debt and the cost of equity, there would be no debate about the rate to use. The reason why there is a difference between the cost of debt and cost of equity is that investors are assumed to be risk averse and to require compensation for the bearing of non-diversifiable risk (i.e. the risk of variability in returns that cannot be avoided by holding a diversified portfolio of assets).¹⁶⁸ This gives rise to an equity risk premium, which is essentially the difference between the cost of debt and the cost of equity, and which accrues to the parties who bear the risk of variability in returns. For a rate that differs from the cost of debt to be of relevance, therefore, there must be some element of risk relating to the variability of returns.

¹⁶⁶ For example, prior to a dispute being raised and concluded it may appear to investors that an overcharging firm holds less debt than it actually does, reducing the perceived risk of the firm's debt compared to the actual underlying position. Debtholders could realise this gain by trading listed debt.

¹⁶⁷ We estimate that the impact of the overcharge on BT's gearing between 2006/07 to 2012/13 was less than 0.2 percentage points in each year. This is unlikely to have significantly affected BT's credit metrics. We consider that any benefits to BT's debt holders as a result of the overcharge were therefore minimal.

¹⁶⁸ In contrast, debtholders get the same amount of return regardless of the performance of the firm (provided that the firm is solvent as at the repayment date)

- 4.28 It follows that one of the key questions in considering the nature of the financing of a project is who is bearing the risk that arises from the variability of project returns. That is, in order to finance a project, it is necessary both to obtain funds and to identify the bearers of that risk. A project cannot properly be regarded as financed unless the parties who bear the impact of reduced returns or losses in the event of bad outcomes have been identified. If those parties are not identified, the risk does not go away: in that case there is lack of clarity about who is bearing the risk, but the risk still exists. For the project¹⁶⁹ to be properly financed, that uncertainty needs to be resolved.
- 4.29 Therefore, in considering the question of how a project is financed, and the net financing burden falling on individual parties, it is necessary to consider both the shares of funding and the distribution of risk among the parties. For the net financing requirement of a project to be reduced, it is necessary to establish that a share of both funding and risk is removed from the original providers of finance.
- 4.30 In our view, therefore, the way to determine that there has been a reduction in the net financing requirement, that is meaningful in this context, is that there needs to have been a reduction in the amount of risk that is borne by the firm's existing shareholders, since they bear the risk of variability of returns (i.e. the return they make is based on the performance of the firm).¹⁷⁰
- 4.31 We now assess whether the overcharge in this case leads to a reduction in BT's net financing requirement. This would require the level of risk borne by the existing shareholders to be reduced as a consequence of the overcharged parties taking on an amount of risk associated with the project. This would be the case if the repayment of the overcharge reflected the variability of the returns to BT's activities. However, the repayment of the overcharge that we are considering is fixed and does not vary with BT's financial performance: BT is required to repay to the Disputing Parties the amount of the overcharge as determined by Ofcom. Consequently, the existing shareholders bear the same risk as they would bear in the absence of the overcharge.
- 4.32 Accordingly, in our view it is not correct to regard the overcharge as constituting a reduction in BT's net financing requirement. It is better regarded as a source of finance; in particular, it is a form of finance that does not bear the risk of variability of returns.

The benefit of the overcharge is equivalent to the interest avoided on debt

- 4.33 If we consider the overcharging as a source of financing in this manner (rather than a reduction in BT's net financing requirement), for the period BT retained the overcharge, the effective cost of this financing was zero, so the benefit to BT can be seen as the cost of financing avoided (i.e. the rate it otherwise would have had to pay to obtain an equivalent sum of money using an equivalent method of financing). The

¹⁶⁹ It is helpful to distinguish between financing an investment to get a project started (e.g. the capital cost of infrastructure etc) and the financing of the project, which involves accepting the risk of variation in the returns generated by the project. One illustration of this difference may be seen by considering what happens in the situation where, in a particular period, the project generates negative cashflows - i.e. there are costs that are not covered by project revenues, and someone has to cover these costs. For the project, as opposed to the initial investment, to be financed, there must be a party with responsibility for covering those costs.

¹⁷⁰ In principle, we could consider the effect on debtholders and the risk they face. In our view, this is not material in this context - see footnotes 166 and 167.

relevant question is then the nature of the financing that the overcharge replaced, equity, debt or some mix of the two.

- 4.34 As noted above in relation to the question of whether the overcharge reduces BT's net financing requirement, with equity financing, an investor's return is dependent on the performance of the firm (whereas a debtholder would generally expect a fixed return dependent only on the company remaining solvent at the date of repayment).¹⁷¹ This is not the case with the overcharge – the equity risk faced by BT's shareholders remained unchanged. For this reason we do not consider that the overcharge is akin to equity. If BT's shareholders did not face a reduced equity risk as a result of holding the funds arising from the overcharge then we do not consider that the appropriate interest rate should be based on either the cost of equity, or, by extension, the WACC, since the WACC represents the weighted average of both the cost of debt and cost of equity.
- 4.35 We consider that the overcharge is akin to debt because it represents a sum of money that, consequent on Ofcom's determination that it is an overcharge in breach of BT's regulatory obligations and should be repaid, must be repaid in full, and the amount that BT has to repay the Disputing Parties is the same regardless of BT's performance. We recognise that BT's and the Disputing CPs' contemporaneous view of the nature of the overcharge may have been different. This is because the Parties may have been uncertain whether BT would have to repay the overcharged parties until Ofcom determined that there had been an overcharge and ordered repayment. However, taking into account the fact that we determined that BT overcharged and that we ordered repayment, in our view the true nature of the overcharge is more important in considering the benefit to BT than BT's or the Disputing CPs' contemporaneous view which may have been erroneous.¹⁷²
- 4.36 We note that AlixPartners have argued that we have failed to consider the interaction between debt, equity and balance sheet capacity, and the indirect impact that an overcharge will have on gearing and on the cost of equity. AlixPartners have referred to the MM irrelevance theorem, which states that if a company issues debt, the overall cost of financing is equal to the WACC because of the indirect impact that the increase in gearing will have on the cost of equity.
- 4.37 In considering the benefit of the overcharge to BT, we have taken into account the implications of the MM irrelevance theorem. The relationships among the variables of the cost of equity, cost of debt and level of gearing established by the MM irrelevance theorem imply that BT can choose its level of gearing, and that its shareholders will bear different levels of risk at each level of gearing and its cost of equity will be commensurate with that risk in each case. It remains open for BT to have increased (or decreased) its gearing, regardless of the overcharge, should it choose to do so. Therefore we consider that the relevant question is whether the overcharge gives benefits to BT's shareholders beyond those that could be achieved by an increase in gearing (assuming the extra debt is available at a zero interest rate, as with the

¹⁷¹ The cost of debt is usually lower than the cost of equity because debt holders face less risk than equity holders. Debt holders face less risk because i) they are paid back before equity in the event of bankruptcy, ii) debt holders receive interest even if the company is loss making (i.e. the amount debt holders receive does not depend on the performance of the company) and iii) debt can be secured against assets (though BT's listed debt tends to be unsecured).

¹⁷² We note AlixPartners' argument that firms that were overcharged may no longer exist in the market, and so will not be repaid. We do not consider it changes our view that the overcharge is akin to debt in this case, as this case relates to the overcharge between BT and the Disputing Parties - the Disputing Parties remain in the market and we have not received any evidence to suggest that there was a material risk that they would exit the market.

overcharge). If the returns to shareholders that are available from replacing equity with the overcharge are no more attractive than those available to BT through a simple increase in gearing, then the benefit of the overcharge would still appear to be equivalent to the cost of debt (i.e. interest on debt avoided).

- 4.38 We have set out below an example to illustrate this type of assessment. This shows that no further options, in terms of risk/return combinations, can be created by the overcharge, beyond the advantage conferred on BT by having access to some element of debt finance at a zero interest rate. At paragraph 3.55 of the Provisional Conclusions, we set out an example in which we assume that BT needs to finance a project costing £1,000. Continuing with this example, in the absence of an overcharge, we assume that this project would be funded equally by £500 debt and £500 equity. For illustration, we assume that the cost of equity is 15% and the cost of debt is 5%.¹⁷³ The WACC in this case would be 10%, and the MM irrelevance theorem tells us that this is the WACC at any level of gearing and it is also the ungeared cost of equity. We then consider what would happen if BT had an overcharge of £200, which represents a debt obligation with 0% interest. We consider two scenarios; first, the overcharge replaces debt (maintaining 50% gearing) and second, the overcharge displaces equity (increasing gearing to 70%).
- 4.39 In the first scenario, BT uses the overcharge to replace £200 of the debt required on the project so there is £300 of interest bearing debt and £200 of 0% debt alongside £500 of equity. We assume that competitive conditions in the market are unchanged and that the firm makes the same return on the project in both cases, i.e. £100 (£1,000 x 10%). In both examples we are considering the benefit that BT gained through holding the overcharge (i.e. through having access to the funds from the overcharge over a period of time as set out in paragraph 4.12, not the gain represented by the overcharge itself (i.e. the principal amount of the overcharge, which is assumed to be repaid at a later date).

Table 4.2: The overcharge replaces debt (constant gearing)

	No overcharge	Overcharge replaces debt
Equity (E)	500	500
Debt (D)	500	300
Overcharge (zero interest debt) (D)	0	200
Gearing (D/(D+E))	50%	50%
Payments to debt	25	15
Payments to equity	75	85

- 4.40 When the overcharge replaces debt, debt interest falls from £25 to £15.¹⁷⁴ The firm continues to earn a return of £100 but the equity holders benefit from the additional £10 that the firm is no longer paying out to debt holders. This means the payments to equity increase from 75 to 85 (in percentage terms the returns to equity increase from 15% to 17%, which reflects the impact of gearing on the cost of equity given the

¹⁷³ This scenario is equivalent to having a risk free rate of 5%, an equity risk premium of 5%, and an asset beta of 1. The ungeared cost of equity would therefore be $5\% + (5\% \times 1) = 10\%$. The equity beta, assuming a zero debt beta for simplicity, would be 2. The geared equity beta would therefore be $5\% + (5\% \times 2) = 15\%$. The same conclusions would apply if we made different assumptions about the cost of debt and the cost of equity.

¹⁷⁴ $500 \times 5\% = 25$ without the overcharge and $300 \times 5\% = 15$ with the overcharge.

changes to the cost of debt).¹⁷⁵ The benefit to shareholders in this case is equal to the interest rate avoided on the cost of debt.

- 4.41 In the second scenario, BT uses the overcharge to displace £200 of equity required on the project so that there is £300 of equity, £500 of interest bearing debt and £200 of 0% debt. As before, we assume the firm earns the same return in both cases (with and without the overcharge), i.e. £100 (£1,000 x 10%). In this scenario gearing increases from 50% with no overcharging to 70% with the overcharge.
- 4.42 As noted above, the relevant question at this point is whether the returns to shareholders that are available from replacing equity with the overcharge are more attractive than those available to BT through a simple increase in gearing. This is considered in the table below.

Table 4.3: The overcharge displaces equity (higher gearing)

	No overcharge	Increase gearing	Overcharge displaces equity
Equity (E)	500	300	300
Debt (D)	500	700	500
Overcharge (zero interest debt) (D)	0	0	200
Gearing (D/(D+E))	50%	70%	70%
Payments to debt	25	35	25
Payments to equity	75	65	75

- 4.43 The fourth and third columns compare the position with the overcharge and without the overcharge but with an equivalent increase in gearing. Absent the overcharge, BT could choose to increase gearing from 50% to 70%. In this case, debt interest would increase from £25 to £35 and payments to equity would decrease from £75 to £65 (and the cost of equity would increase from 15% to 21.67% in order to maintain a WACC of 10%).¹⁷⁶
- 4.44 With the overcharge replacing equity, the firm continues to earn a return of £100 but the equity holders benefit from the additional £10 that the firm would have been paying out to debt holders if it had increased gearing as in the third column. This means the payments to equity increase from 65 to 75 (in percentage terms the returns to equity increase from 21.67% to 25%, which reflects the impact of gearing on the cost of equity given the changes to the cost of debt).¹⁷⁷
- 4.45 In the case where there is no overcharge (and 50% gearing), as set out in the second column, the returns to equity are 15%. This increases to a 25% return in the case where there is an overcharge replacing equity (and 70% gearing), as set out in the fourth column. The overall increase from 15% to 25% comprises both (i) an increase in return to reflect higher equity risk (due to the higher gearing) and (ii) an increase to

¹⁷⁵ The cost of debt is now $(£300 \times 5\% + £200 \times 0\%) / £500 = 3\%$. With gearing unchanged at 50%, the cost of equity increases from 15% to 17% in order for WACC to remain unchanged.

¹⁷⁶ Debt interest: $500 \times 5\% = 25$ with 50% gearing and $£700 \times 5\% = 35$ with 70% gearing. Cost of equity: with 70% gearing the cost of equity needs to rise to 21.67% in order for WACC to be unchanged at 10%. At this cost of equity the payments to equity are $£300 \times 21.67\% = £65$ compared to $£500 \times 15\% = £75$ before).

¹⁷⁷ The cost of debt is now $(£500 \times 5\% + £200 \times 0\%) / £700 = 3.6\%$. With gearing unchanged at 70%, the cost of equity increases from 21.67% to 25% in order for WACC to remain unchanged at 10%.

reflect the benefit of the overcharge. The impact on equity of the increase in gearing is an increase in the return from 15% to 21.67% (as in the third column). This is not a windfall gain but reflects the increased equity risk associated with higher gearing. The impact on equity of the overcharge is an increase in the return from 21.67% to 25% reflecting the interest avoided on the cost of debt¹⁷⁸. The overall benefit of the overcharge to shareholders in this case is therefore also equal to the interest rate avoided on the cost of debt.

Summary of our reasons for concluding that the benefit of the overcharge is the cost of debt

- 4.46 We think it is appropriate to consider the benefit to BT's shareholders and that in assessing the appropriate interest rate we are concerned with considering the opportunity cost to BT derived from the overcharge.
- 4.47 We do not consider that the overcharge reduced BT's net financing requirement. Instead we think it is more appropriate to view the overcharge as a change in the nature of the financing available. That is essentially because the overcharge has not led to any reduction in the risk faced by BT's existing shareholders, because the repayment of the overcharge does not change with variability of BT's returns, and the Disputing Parties have not taken on any equity risk (i.e. they will be repaid regardless of BT's performance).
- 4.48 Instead, we consider that the overcharge is a form of financing more akin to debt, in that it represents a sum of money that, consequent on Ofcom's determination that it is an overcharge in breach of BT's regulatory obligations and should be repaid, must be repaid in full, and that the benefit to BT is equivalent to the interest avoided on debt.
- 4.49 In addition, in terms of indirect effects on gearing, we do not consider that the overcharge provides BT with any opportunities to adjust the rate of return to equity which would not have otherwise existed by making adjustments to its gearing. We therefore consider that this also supports the view that the benefit to BT (in terms of its shareholders) is equivalent to the interest rate avoided on the cost of debt.

BT's actual use of overcharge

- 4.50 As noted above, BT considers that Ofcom should adopt a rate of BOE+1% in line with the Interest Guidance. However, BT argues that, if Ofcom intends to depart from BOE+1%, it should take into account what BT actually did with the funds. In this case BT argues that it was building up a significant cash surplus during the relevant period and the overcharge would have been added to this, earning a relatively low cash deposit rate.
- 4.51 We disagree with BT that the cash deposit rate reflects the benefit of the overcharge to BT.¹⁷⁹ As explained above, we consider that the benefit of the overcharge to BT is

¹⁷⁸ The interest avoided is 10 which on an equity base of 300 represents an increase of 3.3% (10/300). Therefore 21.67% + 3.3% = 25%.

¹⁷⁹ While BT did have large cash balances during the relevant period, we are not convinced that this in itself demonstrates that the cash from the overcharge was simply held as cash. Over the same period for example BT spent an average of c£3bn per year on capital expenditure. Any analysis of the actual use of the overcharge funds would have to consider the extent to which the overcharge could have been used to fund capex programmes.

the opportunity cost associated with the overcharge. As also noted above, this is not necessarily the same as how BT actually chose to use those funds in practice¹⁸⁰.

- 4.52 As explained above at paragraphs 4.33 to 4.45, we consider that the overcharge gave BT the opportunity to avoid the cost of debt over the period during which it reasonably expected to retain the overcharge. Whilst it is possible for an overcharging firm to use an overcharge to build up a cash surplus, a firm acting rationally would only use the overcharge to increase its cash balances with the expectation that it would provide a benefit at least as great as the alternative of repaying debt or avoiding taking out debt of an equivalent term. We consider, therefore, that the use of a cash deposit rate (which would generally be lower than the cost of debt) is unlikely to meet our main objective of avoiding CPs having incentives to set unduly high charges in most circumstances.
- 4.53 As set out in the Provisional Conclusions, we consider that the cash deposit rate may be appropriate where it reflected the financing opportunities available to BT as a result of the overcharge, for example, where BT could have reasonably expected to have to repay the overcharge within a short period of time, such that it would not be practicable to repay debt, or where it had no opportunity to repay debt or avoid taking out additional debt.¹⁸¹ In this case, even though BT may have had a cash surplus during the relevant period, we do not consider that the above factors apply, and that BT would have had the opportunity to repay debt or avoid taking out new debt, because:
- i) we conclude in paragraphs 4.79 to 4.93 that BT could have reasonably expected to retain the overcharge for between three and five years;
 - ii) BT had bonds in issue during this period that it could have repaid or partially repaid; and
 - iii) BT issued ten bonds between 1 October 2006 (when the overcharge is deemed to have started) and 28 December 2012 (when the principal was repaid), for a total of around £7bn.¹⁸²

Final conclusions on the approach towards setting an interest rate that reflects the time value of the overcharge

- 4.54 We consider that it is reasonable to expect that the opportunity cost to BT associated with the overcharge would reflect its cost of debt. This is because where a debt carries zero interest, as was the case with the overcharge, the benefit to BT's shareholders is the interest rate that would have otherwise been paid on debt. We therefore conclude that it is reasonable to expect that an interest rate based on cost of debt best reflects the time value of the overcharge to BT.

¹⁸⁰ For example, BT could have used the overcharge to invest in a project giving a 20% return, or it alternatively could have raised debt finance to invest in the same project earning 20%. The only difference between raising debt finance and financing the project using the overcharge is the interest avoided on debt which might otherwise have been taken out or retired.

¹⁸¹ This might be the case, for example, if BT had little debt in issue.

¹⁸² BT issued debt on the following dates, with currency and value in brackets. Applying the exchange rates applicable on the date of issue, the total raised is around £7bn: 21 June 2007 (€750m); 21 June 2007 (£500m); 21 June 2007 (£500m); 22 November 2007 (€1bn); 12 December 2007 (\$850m); 12 December 2007 (\$1.1bn); 25 June 2008 (€1bn); 11 June 2009 (€600m); 22 June 2012 (\$500m); 22 June 2012 (\$750m).

Whether BoE+1% is an appropriate proxy for BT's cost of debt in this case for the period 2006 to 2012

Introduction

- 4.55 In the Interest Guidance we said that BoE+1% is generally likely to provide a reasonable approximation of the cost of debt for an overcharging CP such as BT. We recognised, however, that it may be appropriate to depart from that rate where such a departure was supported by evidence.
- 4.56 In the Provisional Conclusions, we carried out a cross-check to assess whether BoE+1% lay outside the range of the cost of debt to BT that may reasonably be expected in the circumstances of this dispute. We specifically compared the BoE rate to yields on BBB bonds maturing in one to five years.
- 4.57 Our provisional view was that adopting a rate of BoE+1% would not, in the particular circumstances of this case, provide a reasonable and appropriate estimate of the cost of BT's debt during the period 2006 to 2012, regardless of the assumptions made as to the appropriate 'term' of the debt (i.e. the period for which BT may reasonably have expected to hold the benefit of the overcharge). This was because the evidence indicated that during the 2006 to 2012 period there was not a stable relationship between the BoE rate and yields on BBB bonds¹⁸³ for one to five year terms.

Parties' views

- 4.58 AlixPartners agree that if a cost of debt approach is applied then BoE+1% is not an appropriate interest rate.¹⁸⁴
- 4.59 BT says we should award interest at a rate of BoE+1% for reasons of regulatory and commercial certainty.¹⁸⁵

Ofcom's views

- 4.60 In the Gamma Determination, we emphasised that we consider it is important to adopt an approach to awarding interest that will foster commercial and regulatory certainty. We therefore set out a position that "*it is likely to be appropriate to adopt the Bank of England base rate plus 1% in most cases as a rate that would reflect the benefit derived by the overcharging firm from the overcharge, in the absence of clear and substantive evidence that this rate would fail to meet our regulatory objectives, would be unfair to one of the parties or otherwise inappropriate.*"¹⁸⁶
- 4.61 We said in the Interest Guidance that:

"... we recognise that, depending on the facts of a particular case, it may be appropriate to depart from that rate in order to ensure that our objectives, in particular our main objective, are met. If parties put forward relevant evidence which suggests that an alternative rate should be applied in a given case, we

¹⁸³ We consider that yields on BBB bonds provide a reasonable estimate of BT's cost of debt because BT was BBB rated throughout this period.

¹⁸⁴ Third Alix Report, paragraph 3.3.1.

¹⁸⁵ BT's response to the Provisional Conclusions, 17 July 2015, paragraph 37.

¹⁸⁶ Gamma Determination, paragraph 3.121

would consider it. In most cases, we would expect that parties to a dispute should be in a position to put forward reasoned and evidence-based submissions as to why they consider that the Bank of England base rate plus 1% would not be appropriate in the circumstances of a given dispute, for example, because they consider it would not meet our regulatory objectives or would be unfair to one of the parties.”¹⁸⁷

- 4.62 We said that we believed that the approach set out in the Interest Guidance “represents a pragmatic solution that parties to future disputes will be familiar with and should help promote regulatory and commercial certainty, whilst ensuring that our approach to interest is sufficiently flexible to ensure that the level of interest awarded in a given case achieves our regulatory objectives and is fair as between the parties.”¹⁸⁸
- 4.63 We do not consider that the approach that we set out in the Provisional Conclusions undermines commercial and regulatory certainty. As we set out in the Interest Guidance, an interest rate of BoE+1% would generally be likely to be an appropriate rate to reflect the benefit derived by an overcharging firm. We indicated that that may not be the case in all circumstances and that there may be circumstances in which a departure is appropriate where a rate of BoE +1% would not ensure that our regulatory objectives are met. The approach that we proposed in the Provisional Conclusions followed the approach set out in the Interest Guidance, as we took BoE+1% as our starting point, but considered, on the facts of this case, that it was appropriate to depart from that rate. We remain of the view that it is appropriate to depart from BoE +1% in this case for the reasons set out above.

Final conclusions on whether BoE+1% is an appropriate proxy for BT’s cost of debt in this case for the period 2006 to 2012

- 4.64 We continue to consider that, as set out in the Provisional Conclusions, the evidence demonstrates that during the 2006 to 2012 period, there was not a stable relationship between the BoE rate and yields on BBB bonds for one to five year terms (as a proxy for BT’s cost of debt).¹⁸⁹ Given the unstable relationship between the BoE rate and yields on BBB bonds during the period in question, adopting a rate of BoE +1% may benefit the overcharging firm since it would provide a significantly lower rate of interest than the cost of debt during the period. A rate of BoE +1% would not therefore meet our main objective of avoiding the creation of an incentive for CPs to set unduly high charges.
- 4.65 We therefore conclude that adopting a rate of BoE+1% would not, in the particular circumstances of this case, provide a reasonable and appropriate estimate of the cost of BT’s debt during the period 2006 to 2012.

The appropriate approach to calculating a proxy for BT’s cost of debt in this case

Introduction

- 4.66 In light of our conclusion that BoE+1% does not provide a reasonable estimate of the benefit to BT of retaining the overcharge in the circumstances of this case, we need to consider an alternative approach to calculating an interest rate which would be

¹⁸⁷ Gamma Determination, paragraph A2.13

¹⁸⁸ Gamma Determination, paragraph A2.14

¹⁸⁹ Provisional Conclusions, paragraphs 3.72 to 3.76

appropriate to reflect the benefit that BT derived from the overcharge. As we set out in paragraph 4.54, we consider that this would be a rate reflecting BT's cost of debt.

4.67 We consider the following factors:

- Point of overcharging and compounding.
- Term of the debt on the principal overcharge.
- Yield on debt associated with the relevant term.

Point of overcharging and compounding.

4.68 In order to estimate an interest rate we need to establish the point during the relevant financial year at which the overcharge is assumed to have occurred. We also need to decide the intervals at which interest should be compounded. Our provisional view was that we should assume that the overcharge occurs at the mid-point of the financial year on 1 October each year, e.g. the overcharge relating to the 2006/07 financial year occurred on 1 October 2006 and on 30 September 2007 it attracted a year's worth of interest; and that interest should be compounded annually.

Parties' views

4.69 AlixPartners agree with our provisional view.¹⁹⁰

4.70 BT has not specifically commented on our provisional view, although we note that in the revised calculations BT has put forward, it has been assumed that the overcharge occurred at the mid-point of the year and compounding has been included.¹⁹¹

Final conclusions on the point of overcharging and compounding.

4.71 For the reasons given in the Provisional Conclusions¹⁹² we remain of the view that it is appropriate to assume that the overcharge occurs on 1 October each year and that interest should be compounded annually.

Term of the debt on the principal overcharge

4.72 Our provisional view was that BT could have reasonably expected to retain the overcharge for between three and five years, with a central estimate of four years. The lower bound of three years represented a period ending four months after Ofcom accepted the Initial Disputes for resolution (i.e. the period ending on 13 January 2011),¹⁹³ and the upper bound of five years represented the actual period that BT retained the principal (i.e. the period ending on the date BT repaid the principal, 28 December 2012). In choosing a central estimate of four years we said that in the circumstances of this case it may have been reasonable for BT to expect that it could

¹⁹⁰ Third Alix Report, 17 July 2015, paragraph 3.3.2.

¹⁹¹ These calculations are referred to in paragraph 40 of BT's response to the Provisional Conclusions, 17 July 2015.

¹⁹² Provisional Conclusions, paragraphs 3.79 to 3.81.

¹⁹³ Ofcom must resolve disputes within a four month statutory deadline, except in exceptional circumstances. Exceptional circumstances applied in the Ethernet Disputes, as described in paragraph 3.92 of the Provisional Conclusions.

take longer to resolve the Ethernet Disputes than the statutory four month period, as a result of the exceptional circumstances which applied in this case.

Parties' views

- 4.73 AlixPartners consider that Ofcom has put excessive weight on the actual and expected holding period of the overcharges. It believes that it is more appropriate to take account of BT's portfolio of debt since there was no evidence of any substitution of the overcharges for debt of any particular maturity.¹⁹⁴
- 4.74 BT has provided evidence that it made provisions associated with Ethernet overcharges in 2009/10, 2010/11 and 2011/12.¹⁹⁵ BT says that "*the very act of making such a provision means that the funds were not thereafter available to reduce or repay medium term corporate bonds*".¹⁹⁶ BT says that this has two consequences.
- For the amount of the overcharge for which BT has made a provision, it is not possible to suggest that it could reasonably expect to retain the overcharge for longer than a year after the provision was made.¹⁹⁷
 - The effect of the provisions is to reduce the duration over which BT could have reasonably expected to retain the amount of the overcharge for which no provision was made.¹⁹⁸
- 4.75 BT argues that the overall effect of the provisions is to reduce below three years the period for which BT had a reasonable opportunity to use the overcharge (whether using an expected repayment date of 13 January 2011 or 28 December 2012 for the amount of the overcharge for which no provision was made.¹⁹⁹).²⁰⁰
- 4.76 In estimating the term of the debt, BT does not consider that the actual period is an appropriate starting point for assessing how long BT could have reasonably expected to retain the overcharge. It argues that it took Ofcom almost 2.5 years to resolve the dispute as opposed to the period of four months which could reasonably be expected by BT at the time.
- 4.77 BT adds that for the first three years of the overcharge period (April 2006 to March 2009) BT could have no idea that the resolution of any Ethernet dispute would be so interlinked to any decisions of the CAT and Court of Appeal in the PPC case, which means it could not have reasonably expected the dispute resolution process to take over two years longer than usual.²⁰¹
- 4.78 BT also says that in considering BT's reasonable expectation of the term, "*it should not be overlooked that both BSkyB and Talk Talk had intimated that it would bring a dispute to Ofcom in January 2008 if a commercial settlement could not be achieved*."²⁰²

¹⁹⁴ Third Alix Report, paragraph 3.3.5.

¹⁹⁵ This evidence includes papers for BT Group plc Board Audit and Risk Committee on Group provisions from March 2011 and March 2012.

¹⁹⁶ BT's response to the Provisional Conclusions, 17 July 2015, paragraph 23.

¹⁹⁷ BT's response to the Provisional Conclusions, 17 July 2015, paragraph 24.

¹⁹⁸ BT's response to the Provisional Conclusions, 17 July 2015, paragraph 43.

¹⁹⁹ BT's response to the Provisional Conclusions, 17 July 2015, paragraph 43.

²⁰⁰ BT's response to the Provisional Conclusions, 17 July 2015, paragraph 25.

²⁰¹ BT's response to the Provisional Conclusions, 17 July 2015, paragraph 29.

²⁰² BT's response to the Provisional Conclusions, 17 July 2015, footnote 43.

Ofcom's views

- 4.79 In estimating the term of debt our objective is to consider the period over which BT could reasonably have expected to retain the overcharge. In paragraph 3.84 of the Provisional Conclusions we set out some factors that could be relevant in determining BT's reasonable expectation of the period it would retain the principal.
- 4.80 We consider that an assessment of BT's reasonable expectation should be informed by the facts of the case. We consider three facts to be particularly relevant:
- 4.80.1 The actual period that BT retained the principal: As set out in paragraph 3.87 and Table 3.3 of the Provisional Conclusions, BT repaid the principal on 28 December 2012. Assuming that each overcharge occurred at the mid-point of each financial year, BT retained the principal, on average, for five years.
- 4.80.2 The period associated with the dispute being resolved within a four month period of it being submitted to Ofcom: As set out in paragraph 3.90 and Table 3.4 of the Provisional Conclusions, the Initial Disputes were referred to Ofcom in July 2010 (following a period of negotiation between BT and Sky and TalkTalk) and accepted by Ofcom on 13 September 2010. Therefore, in practice, the earliest that BT could have been ordered to make repayment would be around four months later, i.e. around 13 January 2011. Assuming an anticipated repayment date of 13 January 2011, BT would have retained the overcharge for an average period of three years.
- 4.80.3 The fact that exceptional circumstances applied in this case: As set out in paragraphs 3.92 to 3.95 of the Provisional Conclusions, when Ofcom accepted the Initial Disputes for resolution, the CAT was in the process of hearing appeals against Ofcom's determination of the PPC Disputes and, as a result, on 5 October 2010 Ofcom announced that it considered there were exceptional circumstances in this case.²⁰³ As set out in paragraphs 3.93 to 3.94 of the Provisional Conclusions, BT appeared at the time to agree that exceptional circumstances applied to this case and it also appealed Ofcom's decision to accept the Initial Disputes to the CAT.
- 4.81 BT argues that two further facts are relevant, which we consider below:
- it made provisions for part of the overcharge from 2009/10; and
 - Sky sent BT a letter regarding Ethernet prices in January 2008.
- 4.82 The international accounting standard dealing with provisions (IAS 37²⁰⁴) says that a provision is a liability of "*uncertain timing or amount*".²⁰⁵ A provision is recognised if:
- a present obligation (legal or constructive) has arisen as a result of a past event;

²⁰³ See http://stakeholders.ofcom.org.uk/enforcement/competition-bulletins/closed-cases/all-closed-cases/cw_01052/

²⁰⁴ <http://eifrs.ifrs.org/eifrs/bnstandards/en/2015/ias37.pdf>

²⁰⁵ IAS 37, paragraph IN2. BT recognises this at paragraph 36 of its response where it says "a provision is a liability where the exact amount and timing is still subject to some uncertainty".

- payment is probable (“more likely than not”); and
 - the amount can be estimated reliably.²⁰⁶
- 4.83 The accounting standard does not require that in making a provision, the payment of the provided amount needs to be imminent or due within a year; in fact, the standard recognises that the timing of the corresponding payment is uncertain. However, liabilities (of which provisions are an example) are split on the balance sheet between current and non-current liabilities. Current liabilities are those for which payment is expected to fall due within the following year²⁰⁷, while non-current liabilities are those for which payment is expected to fall due in more than a year. BT has confirmed that the provisions associated with Ethernet were included within non-current liabilities in the 2009/10 and 2010/11 financial years and in current liabilities in the 2011/12 financial year.²⁰⁸
- 4.84 We are not persuaded that the provisions recorded against non-current liabilities in 2009/10 and 2010/11 represent evidence that BT expected to retain the overcharge for less than a year after the provision was made because non-current liabilities are those that the company does not expect to have to repay within a year.²⁰⁹ As a result, we do not consider that the fact BT made a provision in 2009/10 and 2010/11 affects our estimate of the period BT could have reasonably expected to retain the overcharge in this case.
- 4.85 However, we consider that the fact that the provision recorded in 2011/12 was recorded against current liabilities could be indicative that BT expected to retain the overcharge for less than a year after this particular provision was made. Assuming that this provision was made on 1 October 2011 (the mid-point of the financial year, consistent with our assumption of when the overcharge occurred), the fact it was recorded against current liabilities would support an expected repayment date of (or before) 1 October 2012, i.e. a year later.²¹⁰
- 4.86 However, even if we assume that BT expected to repay in a year the amount of the overcharge provided for in 2011/12, this would not significantly affect the upper bound of our three to five year range. If we assume that it was reasonable for BT to expect to repay:
- the amounts provided for in 2010/11 on 1 October 2012; and
 - the amount of the overcharge for which no provision was made on 28 December 2012 (the actual date of repayment),

²⁰⁶ IAS 37, paragraph IN2.

²⁰⁷ IAS1, paragraph 69. <http://eifrs.ifrs.org/eifrs/bnstandards/en/2015/ias01.pdf>

²⁰⁸ Email from BT to Ofcom, 10 August 2015.

²⁰⁹ BT has told us that regulatory provisions in the Group balance sheet are not recorded individually, as the provisions cover all identified regulatory matters (although it said that Ethernet was a large share of this total). BT explained that it recorded its regulatory provisions against Non-current liabilities in 2010 and 2011 and against current liabilities in 2012. BT said that the treatment of provisions changed in 2012 “as a result of more attention being paid to this amount, which had been increasing, and that until this time the financial recording system used Non-current as its default position”. They also said that “even the earliest provision (2010) was in effect recognised as being payable within 3 years due to the change we made in 2012 (which impacted the whole cumulative provided amount).” We do not consider this materially changes our analysis. Email from BT to Ofcom concerning provisions, 10 August 2015.

²¹⁰ We note that the actual repayment date was 28 December 2012.

then the average period that BT would have expected to retain the overcharge would be 4.8 years. This is illustrated in Table 4.4.

Table 4.4: The impact of BT's 2010/11 provision on the expected term of debt

Overcharge occurred	Overcharge amount (£)			Expected term (years)		
	2010/11 Provision	No provision	Total	2010/11 Provision	No provision	Weighted average
01-Oct-06	[✂]	[✂]	[✂]	6.0	6.2	6.1
01-Oct-07	[✂]	[✂]	[✂]	5.0	5.2	5.1
01-Oct-08	[✂]	[✂]	[✂]	4.0	4.2	4.1
01-Oct-09	[✂]	[✂]	[✂]	3.0	3.2	3.1
01-Oct-10	[✂]	[✂]	[✂]	2.0	2.2	2.1
Total	[✂]	[✂]	94,620,000			4.8

Source: BT's response to the Provisional Conclusions, 17 July 2015

- 4.87 The lower bound of our three to five year range would not be reduced since this is driven by an expected repayment date of 13 January 2011 which is before the 2011/12 provision was made.
- 4.88 Therefore, we do not consider that our estimate of the period BT could have reasonably expected to retain the overcharge is significantly affected by the fact it made provisions against current liabilities in 2011/12. While this might slightly reduce the upper bound of our three to five year range, we do not consider that it affects our central estimate of the term of four years.
- 4.89 In relation to the January 2008 letter referred to by BT, Sky wrote to BT on 10 January 2008 challenging BT's Ethernet prices, which Sky hoped could be "*resolved without recourse to Ofcom*".²¹¹ This correspondence represented the first of a number of letters and meetings between Sky, TalkTalk and BT concerning Ethernet prices which lasted over two years. We are not convinced that the letter from Sky to BT in January 2008 commencing commercial negotiations can be used to infer anything about BT's reasonable expectations over how long it would retain the overcharge in this case, other than BT could have expected Sky and TalkTalk to refer a dispute to Ofcom once the parties had reached a point where commercial negotiations between them failed to resolve the issue.
- 4.90 Overall, we do not consider that the two additional facts referred to by BT affect our view of the appropriate term, i.e. that BT could have reasonably expected to retain the overcharge for between three and five years, and that it is appropriate to take the mid-point of four years as a reasonable estimate.
- 4.91 We disagree with AlixPartners that it would be appropriate to assume a term equal to that on BT's portfolio of debt. The average maturity of BT's outstanding listed debt during the relevant period was between six and nine years.²¹² We do not consider that the facts of this case support a finding that BT could have reasonably expected to retain the overcharge for as long as this, for the reasons explained above.

²¹¹ BT's response to the Provisional Conclusions, 17 July 2015, footnote 43.

²¹² This represents the simple average of debt outstanding as at 30 September in each year 2007 to 2013. The weighted average is similar, around seven to ten years (weighted by debt outstanding).

Adopting a term of this length risks overestimating the opportunity that BT had to avoid debt or repay debt.

- 4.92 We acknowledge that during the period 2006-2009 BT could not necessarily have predicted that there would be a two year period from the issue of overcharging first being raised before a dispute relating to its Ethernet charges would be referred to Ofcom by Sky and TalkTalk, and would not have known that the PPC appeal would delay the resolution of that dispute for a period of over two years. However, taking into account our discussion above of provisions and the Sky January 2008 letter, we do not consider that BT has provided any cogent evidence to suggest that it could reasonably have expected to retain the overcharge for a period of less than three years (in view of the fact that the dispute was in fact not referred to Ofcom until July 2010). Equally we have regard to the facts set out in paragraph 4.80 above. We consider that the above considerations are consistent with BT reasonably expecting to retain the overcharge for a period of between three and five years. In our view, adopting this range of three to five years and using a central estimate of four years strikes a reasonable balance between the risk of over- and under-estimating what BT's reasonable expectation would have been in this case.

Final conclusions on the term of the debt on the principal overcharge

- 4.93 We conclude that BT could have reasonably expected to retain the overcharge for between three and five years. Within this range we conclude that a reasonable estimate of the term is four years.

Yield on debt associated with the relevant term

- 4.94 Our starting point for estimating BT's cost of debt for three to five year terms was to consider the yields on bonds issued by BT. However, we noted that BT's bonds are issued in different currencies and do not mature in precisely three, four or five years at the mid-point of each financial year. We would therefore need to make assumptions concerning the translation of yields into sterling and interpolating the yields on bonds to obtain an estimated cost of debt for three, four and five year terms. We considered that a simpler and more practicable approach would be to estimate BT's cost of debt using yields on an index of BBB bonds from Bloomberg.

Parties' views

- 4.95 BT state that "*insofar as any measure of debt based on bonds is the correct approach... Ofcom's use of Bloomberg BBB bonds is, BT accepts, the correct starting point.*"²¹³
- 4.96 AlixPartners agree that where overall cost of debt data is available (e.g. yields on BBB bonds) there was no need to split the interest rate into a risk-free rate and a premium.²¹⁴ It also says that if a proxy approach is necessary, a UK BBB bond index would be a reasonable proxy for BT's cost of debt for a given maturity.²¹⁵
- 4.97 AlixPartners argue that it is appropriate to take account of BT's overall portfolio of debt (i.e. all of BT's bonds) when estimating the cost of debt (a point we reject in paragraph 4.91 when considering the appropriate term of the debt). However, AlixPartners also argue that Ofcom did not explain why estimating BT's actual cost of

²¹³ BT's response to the Provisional Conclusions, 17 July 2015, paragraph 12.

²¹⁴ Third Alix Report, 17 July 2015, paragraph 3.3.2.

²¹⁵ Third Alix report, 17 July 2015, paragraph 3.3.12.

debt would be “*too complex*” with respect to (i) deciding over what period to estimate spot and forward exchange rates to translate yields to sterling and (ii) selecting bonds in each year that mature in three to five years and interpolating when the maturity is not within this range. In particular, AlixPartners say that it has put forward a “*logical and straight-forward*” methodology for translating the foreign currency bond yields into sterling.²¹⁶

- 4.98 The Altnets also argue that Ofcom has failed to explain why it has rejected the methodology put forward by AlixPartners in their first report and argue that Ofcom’s suggested approach is “*flawed and inaccurate*” in comparison.²¹⁷

Ofcom’s views

- 4.99 Having decided that the appropriate term for the cost of debt is three to five years with a central estimate of four years, we need to estimate BT’s cost of debt consistent with this term.
- 4.100 As explained in the Provisional Conclusions, given that BT was BBB-rated during the period 2006-2012,²¹⁸ we would expect yields on an index of BBB bonds to be a reasonable proxy of BT’s cost of debt during this period.²¹⁹ Bloomberg has a series of BBB indices covering the 2006-2012 period that are available in a range of maturities, including three, four and five year terms. These are shown in Table 4.5.

²¹⁶ Third Alix report, 17 July 2015, paragraph 3.3.9.

²¹⁷ Towerhouse’s response to the Provisional Conclusions on behalf of Vodafone, Virgin and Verizon, 17 July 2015, paragraph 19 and 20.

²¹⁸ As set out at footnote 167, the impact of the overcharge on BT’s gearing between 2006/07 and 2012/13 was minimal, to the extent that we do not consider that it would have significantly affected BT’s credit metrics and, therefore, its credit rating.

²¹⁹ We note that in the Leased Lines Charge Control consultation (LLCC consultation) published on 12 June 2015 we estimated BT’s debt premium by considering both yields on BT’s outstanding debt and yields on BBB bonds of a similar maturity. During the 12 months to March 2015 the debt premium on BT’s bonds averaged 1.1% (paragraph A9.30 of the LLCC consultation) and the debt premium on BBB bonds with 10 year maturities averaged 1.2% (paragraph A9.32). We consider that this provides support for using BBB bonds as a proxy for BT’s cost of debt for specific maturities.

Table 4.5 Annual yields on Bloomberg BBB indices

Financial year	Year from	3 years	4 years	5 years
2006/07	01 Oct 06	6.0%	6.1%	6.1%
2007/08	01 Oct 07	6.3%	6.4%	6.5%
2008/09	01 Oct 08	5.3%	5.7%	6.0%
2009/10	01 Oct 09	3.4%	3.9%	4.4%
2010/11	01 Oct 10	3.1%	3.6%	4.0%
2011/12	01 Oct 11	2.4%	2.9%	3.3%
2012/13	01 Oct 12	1.8%	2.5%	3.1%

Source: Bloomberg. C4053Y, C4054Y and C4055Y indices. Annual yields are calculated as the simple average of daily yields, where we assume the yield associated with non-trading days is the same as the yield on the last trading day.

- 4.101 We note that AlixPartners argue that we have not explained why we have not followed its proposed methodology for calculating BT's cost of debt using bonds actually issued by BT.²²⁰ However, we do not consider that using BT's cost of debt using bonds actually issued by BT (as suggested by AlixPartners) would provide a more robust estimate of BT's cost of debt for the purposes of calculating an appropriate interest rate in the circumstances of this case.
- 4.102 As explained in the Provisional Conclusions, in order to estimate BT's cost of debt using bonds actually issued by BT we would need to undertake a number of calculations in order to derive an appropriate cost of debt based on a four year term during the relevant period, namely:
- estimating the average yield of BT's existing bonds for each year starting 1 October;
 - translating the yields into sterling using spot and forward currency rates; and
 - identifying bonds in each year that mature in approximately three, four and five years and estimate by interpolation a sterling yield for the relevant term.
- 4.103 There are a number of different assumptions which could be made for each of those steps (in particular steps b) and c)), and depending on the assumptions made, such an approach could result in a rate which was above or below that provided by using yields on an index of BBB bonds. For example, exchange rates can be volatile which means that translating yields on foreign bonds into sterling can be sensitive to assumptions regarding the averaging period for spot and forward exchange rates and the relevant forward rate²²¹. Also, there may be a number of ways to interpolate a

²²⁰ AlixPartners set out their method for calculating BT's actual cost of debt at Annex 3 of the first Alix Report, 2 February 2015. For example they suggested a methodology for translating foreign currency yields into sterling for the purposes of calculating BT's cost of debt based on actual BT bonds.

²²¹ For example, forward rates are available on Bloomberg for discrete periods (e.g. 3, 4 and 5 years) which means an assumption needs to be made about which forward rate to apply to a BT bond with a

sterling yield on a bond or group of bonds in order to estimate the yield for a particular maturity, for example using a simple averaging approach or taking account of an appropriate yield curve.

- 4.104 We accept that assumptions could be made in relation to each of these factors, but changes to these assumptions could produce a different result. If any of the rates calculated using these assumptions appeared anomalous (as compared, for example to the yields on BBB bonds), we consider that it would be necessary to investigate the discrepancy to assess whether it was the result of an inappropriate assumption.
- 4.105 Accordingly, we do not consider that the approach proposed by AlixPartners would necessarily generate a more reliable estimate of the cost of debt in this case than the approach set out in the Provisional Conclusions.

Final conclusions on the yield on debt associated with the relevant term

- 4.106 In view of the fact that estimating BT’s cost of debt using yields on an index of BBB bonds is a straightforward and practicable approach that is likely to provide a reasonable estimate of BT’s cost of debt during the period 2006 to 2012, we consider it more appropriate to adopt that approach in this case.

Final conclusions on the appropriate rate of interest on the principal

- 4.107 We conclude that the appropriate rate of interest in the circumstances of this case is equivalent to the average annual yield on Bloomberg’s BBB bonds with a four year term, as set out in Table 4.8

Table 4.8: Annual interest rates on the principal overcharge

Period	Interest rate
01 Oct 06 – 30 Sep 07	6.1%
01 Oct 07 – 30 Sep 08	6.4%
01 Oct 08 – 30 Sep 09	5.7%
01 Oct 09 – 30 Sep 10	3.9%
01 Oct 10 – 30 Sep 11	3.6%
01 Oct 11 – 30 Sep 12	2.9%
01 Oct 12 – 28 Dec 12	2.5%

Source: Ofcom

Interest on Interest

Introduction

- 4.108 We provisionally concluded that in all the circumstances of the case it would be fair and appropriate for BT to pay an amount representing interest on the unpaid interest

tenor which is not equal to these discrete periods. For example, a BT bond with a tenor of 3.5 years could be translated into sterling with a forward rate of 3 years or 4 years, or some average of the two.

(‘interest on interest’) since December 2012, to ensure that our main objective is met. We also provisionally concluded that, in estimating interest on interest, the appropriate rate of interest should be equivalent to BoE+1%.

Whether BT should be required to pay ‘interest on interest’

Parties’ views

- 4.109 BT does not consider that Ofcom should require BT to pay interest on interest. BT argues that Ofcom does not have jurisdiction to deal with the matter of interest on interest.
- 4.109.1 BT argues that the original disputes did not include any claim for interest upon any unpaid interest amounts. While BT accepts that the need for interest on interest would not have been evident when the Ethernet Disputes were submitted, “*that does not permit Ofcom to determine a dispute that was not actually before it.*”²²² BT argues that section 188(2) of the Act requires Ofcom to reach a decision on the dispute that it has decided to accept, and that Ofcom therefore “*has no statutory power to reach a decision on a dispute it has not accepted and the decision to award interest on upon interest in the Provisional Conclusions is thus beyond its current jurisdiction.*”²²³
- 4.109.2 BT says that the Notices of Appeal lodged by the Disputing Parties “*sought to reverse Ofcom’s original determination of 20 December 2012 that, in accordance with clause 12.2 of the Access Contract, no interest should be paid on the overpayments which Ofcom found at 20 December 2012 BT had received and which should be repaid to the Disputing Parties*” (emphasis in original text). BT states that this “*is not the same as seeking interest upon any interest which should have been paid on 20 December 2012*” (emphasis in original text).²²⁴ BT argues that “*the CAT’s Rules are unambiguous*”, and state that the Notice of Appeal “*shall contain... (d) the relief sought by the appellants...*”²²⁵ BT also notes that no application was made by the Disputing Parties to amend their Notices of Appeal.
- 4.109.3 BT argues that the CAT did not remit the issue of interest on interest back to Ofcom, despite the Altnets having raised the issue in their Submission on Directions to the CAT dated 26 September 2014.²²⁶ BT says that “*if the CAT had intended the ‘interest on interest’ issue to be remitted to Ofcom, it would have made a specific order to that effect (precisely as it did on BT’s application in respect of interest [on ECCs]).*”²²⁷ BT contends that the CAT made no such order because it “*recognised that the Disputing Parties had never raised the point in the Notices of Appeal and/or it never formed part of the scope of the original dispute*”.²²⁸

²²² BT’s response to the Provisional Conclusions, 17 July 2015. paragraph 50.

²²³ BT’s response to the Provisional Conclusions, 17 July 2015. paragraph 51.

²²⁴ BT’s response to the Provisional Conclusions, 17 July 2015. paragraph 52.

²²⁵ BT’s response to the Provisional Conclusions, 17 July 2015. paragraph 54.

²²⁶ BT’s response to the Provisional Conclusions, 17 July 2015. paragraph 57.

²²⁷ BT’s response to the Provisional Conclusions, 17 July 2015. paragraph 59.

²²⁸ BT’s response to the Provisional Conclusions, 17 July 2015. paragraph 59.

4.110 BT also argues that the regulatory objective of avoiding CPs having an incentive to set charges that are unduly high “*is irrelevant when BT has not paid the sum because Ofcom itself has ruled that the sum is not payable.*”²²⁹ BT contends that if Ofcom orders BT to pay interest on interest, “*Far from BT being incentivised not to set charges that are unduly high’, the perverse incentive would be that a party in BT’s position should not follow the decision of the regulator*”.

Ofcom’s view

4.111 We remain of the view that in all the circumstances of the case it is fair and appropriate for BT to pay an amount representing interest on the unpaid interest since December 2012 to ensure that our main objective is met. We consider that, consistent with the decision of the CAT, this best serves to meet the objectives of Article 8 of the Framework Directive, for similar reasons as to why it is appropriate to require the payment of interest on the principal overcharge.²³⁰ That is because if we do not require BT to pay interest in respect of the interest it should have paid in December 2012, BT would be left with a benefit in terms of the time value of having held on to that sum of money until the date of repayment. The objective of requiring BT to make such a payment is not to penalise BT, but rather to ensure that BT does not retain a benefit it only derived as a result of its original overcharging. We therefore disagree that we would be creating a “*perverse incentive*” for BT by requiring a payment of interest on the unpaid interest.

4.112 We also do not accept that we lack jurisdiction to determine this issue as part of the Remitted Matters. We note that BT accepts that Ofcom has power to require the payment of interest in respect of the ECCs adjustment. We therefore do not understand BT to be arguing that Ofcom would in principle lack the power to determine whether interest upon unpaid interest should be payable or to direct BT to make such a payment in the context of resolving a dispute. It is unclear why Ofcom would have the power to consider the question of interest in respect of the ECCs adjustment, but not interest on unpaid interest. As with interest on unpaid interest, the issue of interest on the ECCs adjustment was not considered as part of the original dispute determinations, but instead was first raised during submissions on directions after the CAT’s Judgment was handed down on 1 August 2014,²³¹ and the

²²⁹ BT’s response to the Provisional Conclusions, 17 July 2015. paragraph 61.

²³⁰ We note in this regard that in its Judgment the CAT stated: “*a repayment order that included interest on the overpayment may often be a decision that better achieves the objectives set out in Article 8’, and serves to ensure compliance with SMP charge control obligations, than a decision confined to the repayment of only the principal amount. Where an award of interest is required in order best to achieve those objectives, the statutory language should be read as giving Ofcom the power to make such an award.*” See CAT Judgment, paragraph 289.

²³¹ BT first raised this issue in its submissions on directions dated 12 September 2014. Specifically, BT stated: “*Given the decision which the Tribunal has made on interest (i.e. rejecting the contractual provision that no interest should be paid), it would clearly be unfair for the Disputing CPs to escape payment of interest on the amounts they have themselves been overpaid. BT submits the Tribunal should further direct Ofcom to provide in its re-determination that each Disputing CP do (i) pay to BT the difference between (a) the amount of the overcharge specified in paragraph 3 in Annexes 1 to 5 of the Determination as to the amount BT must pay to the respective Disputing CPs by way of an adjustment for overpayment and (b) the amount of the overcharge as specified in Ofcom’s redetermination and (ii) pay interest on such sum at such rate as is determined to be the appropriate rate following the judgment of the Tribunal on interest dated 1 August 2014.*”

CAT expressly ordered Ofcom to determine the question of interest on the ECCs adjustment on remittal.²³²

- 4.113 While the CAT has not been explicit in its Supplementary Judgment or in the Orders as to whether Ofcom should determine the issue of interest on unpaid interest, as noted in the Provisional Conclusions, we consider that the wording of the CAT's Orders is sufficiently broad to cover the issue of whether a sum should be paid in respect of interest on the unpaid interest. Moreover, as noted above, we consider that the award of interest on the unpaid interest is appropriate in order to ensure that our primary objective (of avoiding creating an incentive to overcharge), and the objectives of Article 8, are met.

The appropriate proxy for cost of debt during the period of interest on interest

Parties' views

- 4.114 BT says that "*If any interest were to be payable as 'interest upon interest', then BT fully accepts that the Gamma Interest Rate is the appropriate rate.*" This is because BT believes that the "*Gamma Interest Rate should constitute an accepted norm for interest on overdue amounts caused through overcharging.*"²³³
- 4.115 BT also says that even if it were right to award interest on interest, Ofcom should adopt a more nuanced approach. BT argues that it was only when the CAT reached its decision that "*there was a clear and binding decision against BT on interest. Up until that point, BT had been entitled to and indeed was perfectly right to accept Ofcom's decision.*"²³⁴ BT believes that any decision to award interest on interest should run from the day of the CAT's Judgment.
- 4.116 The Altnets consider that "*Ofcom is incorrect to apply an interest rate of BoE+1% to interest on unpaid interest given that BT did not recognise the repayment of interest on its balance sheet at the time of the repayment of the overcharge of the principal.*"²³⁵
- 4.117 AlixPartners (with whom Sky and TalkTalk say they agree) argue that we were incorrect to propose BoE+1% as the rate of interest on interest on the basis that it is a reasonable proxy for BT's cost of debt during the period December 2012 to May 2015.²³⁶
- 4.118 AlixPartners say that the Provisional Conclusions reflect our view that interest on interest reflects a short term debt obligation from BT to CPs.²³⁷ They believe that we have failed to consider that at the time of payment of the overcharge principal, there was uncertainty as to whether BT would be required to repay interest on the principal and that this implies that the appropriate interpretation is that BT benefited from a reduction in its net financing requirements. Therefore, AlixPartners believe that a rate

²³² See paragraph 11 of the CAT's Supplementary Judgment and its Orders of 10 December 2014.

²³³ BT's response to the Provisional Conclusions, 17 July 2015, paragraph 48.

²³⁴ BT's response to the Provisional Conclusions, 17 July 2015, paragraph 62.

²³⁵ Towerhouse's response to the Provisional Conclusions on behalf of Vodafone, Virgin and Verizon, 17 July 2015, paragraph 21.

²³⁶ Third Alix Report, 17 July 2015, paragraph 4.3.1

²³⁷ Third Alix Report, 17 July 2015, paragraph 4.3.1

based on BT's WACC is appropriate, at least until August 2014 when the CAT ordered that interest should be payable.²³⁸

- 4.119 AlixPartners argue that from August 2014, an interest rate based on BT's actual cost of debt best represents the benefit to BT of retaining the unpaid interest.²³⁹
- 4.120 The Altnets also note that the Judgment Debts (Rate of interest) Order 1993, which relates to the interest that starts to accrue when a High Court or County Court judgment is handed down (in relation to matters over £5k), is 8%.²⁴⁰ They believe it is therefore clear that BoE+1% would be wrong on the facts of this case, and that BT's WACC would be correct and consistent with statutory requirements and practice in commercial matters.²⁴¹

Ofcom's views

- 4.121 We note BT's comments that, should Ofcom consider it appropriate to award interest on interest, BoE+1% is an appropriate rate for Ofcom to apply in line with the Interest Guidance.
- 4.122 We do not agree with BT that any decision to award interest on interest should only apply from the date of the CAT's decision. As explained at paragraph 4.111, the objective of awarding interest on interest is to ensure that BT does not benefit from the overcharge. BT would have been able to benefit from this sum from the date that it repaid the principal overcharge following the Ethernet Determinations. We therefore consider that interest on interest should be awarded from the date of the repayment of the principal overcharge.
- 4.123 We disagree with the Altnets' argument that BoE+1% is not an appropriate interest rate on the basis that, when the overcharge occurred, there was uncertainty as to whether BT would be required to repay interest on the principal and that this implies that the appropriate interpretation is that BT benefited from a reduction in its net financing requirements.
- 4.124 We remain of the view that interest on interest is akin to a debt obligation from BT to CPs for the same reasons that we consider the principal is akin to debt.²⁴² We therefore continue to consider that it is appropriate to follow the approach to assessing an appropriate rate of interest as set out in the Interest Guidance, and take as our starting point the assumption that BoE+1% is likely to be an appropriate rate to reflect the benefit to BT, provided that it would be within a reasonable range for BT's cost of debt during the relevant period.
- 4.125 We consider that BoE+1% is an appropriate proxy in this case for the reasons set out in paragraphs 3.128 to 3.135 of the Provisional Conclusions and therefore see no reason to depart from the approach set out in the Interest Guidance in this particular case. Although we compared BOE+1% with Bloomberg's index of BBB bonds, not an

²³⁸ Third Alix Report, 17 July 2015, paragraph 4.3.2

²³⁹ Third Alix Report, 17 July 2015, paragraph 4.3.3

²⁴⁰ See <http://www.legislation.gov.uk/ukxi/1993/564/made>

²⁴¹ Towerhouse's response to the Provisional Conclusions on behalf of Vodafone, Virgin and Verizon, 17 July 2015, paragraph 22.

²⁴² See paragraphs 4.33 to 4.45

estimate of BT's actual cost of debt, we do not consider this would change our conclusion for the reasons set out in paragraphs 4.100 to 4.105.

- 4.126 We note the Altnets' comment that the judgment debt rate is 8%.²⁴³ However, the Altnets have not put forward any explanation as to why they consider that may be of relevance in this case. We do not consider that there are any grounds to depart from BoE+1% in this particular case, for the reasons explained in paragraphs 3.128 to 3.135 of the Provisional Conclusions.

Final conclusions on the appropriate rate of interest on interest

- 4.127 We conclude that in estimating interest on interest, the appropriate rate of interest is equivalent to BoE+1%.

Interest on ECCs

Introduction

- 4.128 We provisionally concluded that it is appropriate for BT to receive interest on ECCs and that the appropriate rate of interest is BoE+1%.

Parties' views

- 4.129 Neither the Disputing Parties nor BT commented on Ofcom's provisional conclusions that interest should be awarded on the ECCs repayments at a rate of BoE+1%.

Final conclusions on interest on ECCs

- 4.130 We conclude that BT should be entitled to an amount representing interest on the overpayment due to ECCs at a rate of BoE+1%. As proposed in the Provisional Conclusions, we will calculate a net amount due to the Disputing Parties, and allowing for interest on that net amount only, BT's entitlement to interest on ECCs has been given effect to in this Final Determination.

The total amounts payable as between BT and each of Sky, TalkTalk, and the Altnets

Introduction

- 4.131 In the Provisional Conclusions, we said that, for the period to 28 December 2012 (i.e. the date on which BT made repayments of the principal overcharge as originally calculated by Ofcom in the Ethernet Determinations), BT should be required to pay interest on the adjusted level of principal overcharge (see paragraph 3.108 of the Provisional Conclusions) at the rates set out in Table 3.6 of the Provisional Conclusions.
- 4.132 We also said that BT should be entitled to a refund as at the date of the overpayments it made in respect of ECCs, as set out in Table 3.2 of the Provisional Conclusions.

²⁴³ The Court has power to award interest on a judgment debt under section 17(1) of the Judgments Act 1838 at a rate of 8% per annum, as set out in the Judgment Debts (Rate of Interest) Order 1993

4.133 Table 3.7 of the Provisional Conclusions set out our provisional assessment of the repayments due from BT to the Disputing Parties, showing separately the interest due from BT as at 28 December 2012 on the adjusted level of the principal overcharge and the repayment due to BT in relation to ECCs.

4.134 We also said that BT should make interest payments on the net amount due as at 28 December 2012 from Table 3.7 of the Provisional Conclusions at an annual rate of BoE+1%. The net amount represented the interest due from BT on the principal overcharge less the repayments due to BT relating to ECCs. Making interest payments on this net amount would mean that the interest rate applicable to both interest on interest and interest on ECCs is BoE+1%.

Final conclusions on the total amounts payable as between BT and each of Sky, TalkTalk and the Altnets

Correction for ECC overpayment and interest on corrected principal

4.135 We remain of the view that the approach set out at paragraphs 3.147 to 3.151 of the Provisional Conclusions is appropriate.

4.136 We therefore conclude that BT should pay interest on the principal as set out in Table 4.9. Annex 1 shows the interest due to the Disputing Parties in each year.

Table 4.9: Interest on the principal overcharge and ECC repayments

	ECC repayment	Interest on corrected principal overcharge to 28 December 2012	Net amount payable from BT to Disputing CPs
Sky	[✂]	[✂]	[✂]
TalkTalk	[✂]	[✂]	[✂]
Virgin	[✂]	[✂]	[✂]
CWW	[✂]	[✂]	[✂]
Verizon	[✂]	[✂]	[✂]
Total	(203,000)	22,422,000	22,219,000

Source: Interest on principal is calculated by applying the interest rates from Table 4.8 to the principal amount from Table 4.1. The ECC repayment is taken from Table 3.2.

Interest on interest and on ECC overpayment

4.137 We have concluded that BT is also required to make interest payments on the net amount due as at 28 December 2012 as set out in Table 4.9 at an annual rate of BoE+1%. The net amount represents the interest due from BT on the principal overcharge less the repayments due to BT relating to ECCs. Making interest payments on this net amount means that the interest rate applicable to both interest on interest and interest on ECCs is BoE+1%.

Assessment of consistency of Ofcom's final determinations with our statutory duties and Community obligations

Parties' views

- 4.138 The Altnets believe that the approach set out in the Provisional Conclusions fails to meet Ofcom's own primary objective in setting an interest rate, which is to remove the incentive for BT to set charges that are unduly high.²⁴⁴ They believe that if Ofcom's Final Determinations are consistent with the Provisional Conclusions, the Final Determinations would be legally flawed because such a decision would not be aimed at achieving the objectives set out in Article 8 of the Framework Directive, which requires Ofcom to promote competition, including by ensuring that there is no distortion or restriction of competition in the electronic communications sector. The Altnets argue that *"by failing to meet its own objective 1 [to avoid CPs having an incentive to set charges that are unduly high], Ofcom will fail to meet its statutory duties under [the Act]."*²⁴⁵
- 4.139 The Altnets say that they *"do not consider that Ofcom has properly engaged with and addressed the points made in [the Alix Report]"* and that *"this failure results in procedural flaws in Ofcom's approach."*²⁴⁶ They believe that *"these procedural flaws cause Ofcom to fail to comply with general principles of European Union law including that it must provide sufficient factual and evidential bases and robust and transparent reasoning to justify its decisions as satisfying its objectives..."*²⁴⁷

Ofcom's views

- 4.140 We set out at paragraphs 3.152 to 3.154 of the Provisional Conclusions those of our general duties under section 3 of the Act and the six "Community requirements" set out in section 4 of the Act which are particularly relevant to determining the Remitted Matters.
- 4.141 We do not agree that the approach set out in our Provisional Conclusions or in our Final Determinations is legally flawed. The approach set out in our Provisional Conclusions and Final Determinations is designed to achieve our main objective in awarding interest in such cases, namely avoiding creating an incentive for CPs to overcharge. As we noted in the Gamma Determination, we consider that encouraging CPs not to overcharge each other is likely to benefit consumers. We consider that the determinations we have made as to the Remitted Matters, namely the rate of interest payable in respect of BT's overcharge for Ethernet services and the total amount payable as between BT to each of the Disputing Parties, as well as the questions of interest on interest and interest on ECCs, are therefore consistent with our statutory duties and Community obligations and are appropriate to meet the objectives set out in Article 8 of the Framework Directive.²⁴⁸

²⁴⁴ Towerhouse's response to the Provisional Conclusions on behalf of Vodafone, Virgin and Verizon, 17 July 2015, paragraph 5.

²⁴⁵ Towerhouse's response to the Provisional Conclusions on behalf of Vodafone, Virgin and Verizon, 17 July 2015, paragraph 6-7.

²⁴⁶ Towerhouse's response to the Provisional Conclusions on behalf of Vodafone, Virgin and Verizon, 17 July 2015, paragraph, paragraph 8

²⁴⁷ Towerhouse's response to the Provisional Conclusions on behalf of Vodafone, Virgin and Verizon, 17 July 2015, paragraph 9.

²⁴⁸ See Gamma Determination, paragraph 3.24 for an explanation of how Objective 1 meets our Article 8 objectives.

- 4.142 We do not consider, as the Altnets have suggested, that there are “*procedural flaws*” in the process that we have followed in determining this case. Prior to the issue of the Provisional Conclusions, all Parties were given the opportunity to submit extensive submissions on two occasions. We considered those submissions carefully in developing the Provisional Conclusions and set out our views on the Parties’ initial submissions, together with reasoning as to why we had reached our provisional assessment in sufficient detail to allow the Parties to make an informed response. In line with our Enforcement Guidelines, Parties have been given the opportunity to respond fully to the Provisional Conclusions and we have given careful consideration to those submissions. Parties to the dispute have therefore been given significant opportunities to comment on the issues at hand and on Ofcom’s analysis.
- 4.143 We have also set out in detail the reasoning behind our conclusions in respect of the Remitted Matters, including setting out why we do not agree with submissions made, and have acted transparently in setting this out clearly in both the Provisional Conclusions and this Final Determination. We therefore fail to understand the basis on which the Altnets consider that there may have been any procedural flaw in the process which has led to issue of these Final Determinations.

Summary of final conclusions

- 4.144 Our final conclusions in respect of the Remitted Matters are that:
- 4.144.1 Adjusting for the ECC overpayment, the correct amount of principal overcharge by BT is £94,620,000.
 - 4.144.2 The corrected figure above takes account of the repayment that BT is entitled to in respect of the exclusion of ECCs of £203,000.
 - 4.144.3 The interest on the corrected principal overcharge payable by BT is £22,422,000.
 - 4.144.4 The net amount which BT should repay to the Disputing Parties (i.e. the interest on the corrected principal overcharge less the ECCs adjustment) is £22,219,000.
 - 4.144.5 From 29 December 2012, BT should pay interest on the net amount due to the Disputing Parties at a rate of BoE+1%.
- 4.145 From 29 December 2012, BT is entitled to interest on the ECC overpayment. By calculating a net amount due to the Disputing Parties, and allowing for interest on that net amount only, BT’s entitlement to interest on the ECC overpayment at a rate of BoE+1% has been given effect to in these Final Determinations.

Annex 1

Interest payments on the principal overcharge by year

Table A1.1: Interest on the principal overcharge and ECC repayments

Period ending	30-Sep-07	30-Sep-08	30-Sep-09	30-Sep-10	30-Sep-11	30-Sep-12	28-Dec-12	Total	Total (rounded)
Interest rate	6.1%	6.4%	5.7%	3.9%	3.6%	2.9%	0.6%		
Sky	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
TalkTalk	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Virgin	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
CWW	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Verizon	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Total CPs	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	22,422,231	22,422,000

Source: Ofcom. Total repayments have been rounded to the nearest £000.

Annex 2

Copy of the Interest Guidance

- A2.1 We have included on the following three pages a copy of the Interest Guidance. Paragraph numbering and footnote numbering are the same as Gamma Determination, to which the Interest Guidance was annexed.

Annex 2

Ofcom's guidance on its approach to interest in the context of resolving a dispute involving charges payable under BT's Standard Interconnect Agreement

A2.1 When exercising our powers under section 190(2)(d) of the Communications Act 2003 ("2003 Act") to make a direction requiring a repayment to be made in the context of resolving a dispute, Ofcom will decide whether interest should be payable, and if so, at what rate, taking account of all relevant considerations with a view to setting an amount of principal plus interest which would best meet our statutory duties and regulatory objectives, in particular, with a main objective of avoiding CPs having incentives to set unduly high charges.

A2.2 Providing an indication of our approach to interest and the interest rate that we are generally likely to adopt contributes towards providing a stable and predictable regulatory framework. It also has the practical benefit of avoiding substantial time being spent assessing interest during future disputes. This is helpful given that we must determine disputes within four months (except in exceptional circumstances). Accordingly we have sought to identify the interest rate that we are generally likely to adopt when directing a repayment in order to resolve a dispute relating to charges payable under BT's Standard Interconnect Agreement, as well as our reasoning for selecting that rate.

Our starting point

A2.3 In our view, it is likely to be appropriate to award interest in the majority of cases in which a direction for repayment is considered appropriate in order to avoid creating an incentive for CPs to set charges that are unduly high (in the absence of evidence to the contrary). Doing so is likely to meet our statutory duties in most cases. In particular, our main objective of avoiding CPs having an incentive to set unduly high charges is likely to benefit consumers.¹⁴⁵

A2.4 Our starting point is that the interest rate should generally reflect the time value of the principal to the overcharging firm, i.e. the benefit the overcharging firm enjoys by virtue of the delay between its overcharging and the date on which it makes a repayment.

Approach to an applicable contractual interest rate

A2.5 Where an applicable contractual interest rate is in place, we shall have regard to the extent to which that rate would meet our regulatory objectives, in particular, having regard to the need to foster commercial certainty and a stable and predictable regulatory environment, which are important for the promotion of investment, competition and therefore the interests of consumers.

¹⁴⁵ While this will generally be our main objective, depending on the facts of the dispute it may be appropriate to place weight on other objectives as well.

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- A2.6 We are also likely to consider whether the contractual rate evidences what the Parties have agreed would represent a fair and reasonable proxy for the benefit to the overcharging firm. It might be expected that, where the parties have agreed a contractual rate, this may reflect their desire to ensure that an overcharging party does not benefit from any overpayment. Whether or not this is the case in any dispute may need to be considered on the relevant facts before Ofcom at the time of its decision.
- A2.7 However, where we have grounds to consider that the contractual rate would not meet our statutory duties and regulatory objectives, we may decide that it is not appropriate to apply the contractual rate and will need to consider what rate to apply to ensure that our statutory duties and regulatory objectives are met.¹⁴⁶ In such cases, we are likely to have regard to the principles outlined in paragraphs A2.8 to A2.14 below.
- Overview of our approach*
- A2.8 We consider that it would be reasonable to expect that the opportunity cost to the overcharging firm reflects the cost of debt as it could repay outstanding debt or avoid taking out debt with an additional increase in cash as a result of an overcharge. This implies that a cost of debt rate would be appropriate. The interest rate which would represent the cost of debt to the overcharging firm is determined by two factors:
- a) The term of the debt. In determining an appropriate term of debt to act as a proxy for the overcharge, we would consider the length of time for which the overcharging party could reasonably expect to retain the principal; and
 - b) The premium over and above the risk-free rate which reflects the risk of default by the overcharging firm.
- A2.9 In principle, in order to determine what rate of interest would appropriately represent the time value of the overcharge to the overcharging firm in a particular case, we could seek to assess on a case-by-case basis the *actual* benefit to the overcharging firm as a result of the overcharge in that case. However, such an in-depth assessment would be complex and is unlikely to be practical. For example, we would be likely to need significant data which may not always be available on the facts of a given case.¹⁴⁷ Moreover, given the four month statutory deadline by which Ofcom must resolve disputes, there is unlikely to be sufficient time in which to undertake a detailed assessment of the nature of interest once all issues surrounding the merits of the dispute and the award of the principal amount have been considered.
- A2.10 We also consider that it is important to adopt an approach which will foster commercial and regulatory certainty and that an appropriate interest rate should be readily calculable using available data.
- A2.11 We therefore do not consider that it would be appropriate to seek to assess the *actual* benefit to the overcharging firm in the context of any dispute. Instead, in view of the difficulties which may be involved in seeking to determine a 'theoretically

¹⁴⁶ See *Telefónica O2 UK Ltd and others v British Telecommunications plc* [2012] EWCA Civ 1002, paragraph 74.

¹⁴⁷ For example, it is unlikely to be feasible in practice to identify what the overcharging firm actually did with the funds in question, since they will be intermingled with other revenues.

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accurate' rate which approximates the actual benefit to an overcharging CP in a particular case, we consider that it is reasonable and proportionate to adopt a more pragmatic approach, provided that the applicable rate would be within the range of the cost of debt to the overcharging CP that may reasonably be expected.

- A2.12 We consider that the Bank of England base rate plus 1%, which has conventionally been adopted by the High Court in commercial cases and by the CAT when awarding interest on penalties on appeal¹⁴⁸, is likely to be an appropriate rate to reflect the benefit derived by the overcharging firm from the overcharge in most cases. In the absence of evidence to the contrary, we consider that it is likely to provide a reasonable approximation of the cost of debt for a firm in the position of an overcharging CP.
- A2.13 However, we recognise that, depending on the facts of a particular case, it may be appropriate to depart from that rate in order to ensure that our objectives, in particular our main objective, are met. If parties put forward relevant evidence which suggests that an alternative rate should be applied in a given case, we would consider it.¹⁴⁹ In most cases, we would expect that parties to a dispute should be in a position to put forward reasoned and evidence-based submissions as to why they consider that the Bank of England base rate plus 1% would not be appropriate in the circumstances of a given dispute, for example, because they consider it would not meet our regulatory objectives or would be unfair to one of the parties.
- A2.14 This approach represents a pragmatic solution that parties to futures dispute will be familiar with and should help promote regulatory and commercial certainty, whilst ensuring that our approach to interest is sufficiently flexible to ensure that the level of interest awarded in a given case achieves our regulatory objectives and is fair as between the parties.

¹⁴⁸ See for example, the White Book paragraph 7.017(a) and the Admiralty Commercial Court Guide, paragraph J14.1 in respect of the past practice of the High Court and *Napp Pharmaceutical v DGFT* [2002] CAT 3 at paragraph 13, *Richard W Price v OFT* [2005] CAT 12 at paragraphs 21 to 24 and the CAT Guide to Proceedings at paragraphs 18.4 to 18.5 in respect of the CAT's general practice.

¹⁴⁹ Relevant evidence may include a cross-check suggesting that the Bank of England base rate plus 1% lies outside the range of the cost of debt to the overcharging CP that may reasonably be expected in the circumstances of the dispute (taking account of the factors set out in paragraph A2.8).

Annex 3

Determination to resolve the dispute between BT and CWW

Determination under sections 188 and 190 of the Communications Act 2003 (the “2003 Act”) for resolving a dispute between BT and CWW concerning BT’s charges for Ethernet services

WHEREAS—

- (A) on 20 December 2012 Ofcom determined a dispute between BT and CWW relating to BT’s charges for certain Ethernet services (the “2012 Determination”) finding that BT had overcharged CWW for the provision of the Ethernet services specified in the paragraph 1 of the 2012 Determination (the “Relevant Services”) and for the years specified in that explanatory statement to the 2012 Determination, and directed BT to pay CWW, by way of an adjustment of an overpayment for the Relevant Services, the sum of money set out in the 2012 Determination (the “principal overcharge”);
- (B) on 28 December 2012, BT repaid CWW the amount of the principal overcharge as required pursuant to the 2012 Determination;
- (C) on 20 February 2013 BT and CWW lodged appeals with the CAT against the 2012 Determination;
- (D) on 1 August 2014 the CAT gave its Judgment:
 - allowing CWW’s appeal against Ofcom’s decision not to award interest on the amount of the repayment of the overcharge; and
 - allowing BT’s appeal in respect of an adjustment in relation to Excess Construction Charges (ECCs) costs;
- (E) section 195(4) of the 2003 Act requires the CAT to remit the decision under appeal to Ofcom with such directions, if any, it considers appropriate for giving effect to its decision;
- (F) on 4 December 2014 the CAT issued a Supplementary Judgment and on 10 December 2014 the CAT issued Orders setting out directions in respect of the Appeals;
- (G) the Orders remitted to Ofcom pursuant to section 195(4) of the 2003 Act the following matters for it to determine, as soon as reasonably practicable, in accordance with the Judgment and the Supplementary Judgment:
 - the repayments to which BT is entitled in respect of the exclusion of excess construction costs from its rental costs;
 - the rate of interest payable in respect of BT’s overcharge for Ethernet services;
 - BT’s claim for interest in respect of the repayment on excess construction costs; and

- the total amount payable as between BT and CWW.
- (H) in the explanatory statement accompanying this Determination, Ofcom has set out a revised figure for the principal overcharge for the Relevant Services, taking into account the adjustment which needs to be made in relation to ECCs,
- (I) in the explanatory statement accompanying this Determination, Ofcom has also set out that BT should be required to pay interest on the principal overcharge for the period up to 28 December 2012 and has set out the rates applicable and calculated the amounts due from BT to CWW in respect of this interest.

NOW, therefore, pursuant to the CAT's Orders dated 10 December 2014 Ofcom makes, for the reasons set out in the accompanying explanatory statement, this Determination—

I Declaration of rights and obligations, etc.

- 1 Ofcom gives a direction to BT to pay CWW, by way of an adjustment of an overpayment for the Relevant Services, the sum of £[].
- 2 From 29 December 2012, interest at a rate of Bank of England base rate plus 1% compounded annually shall be payable by BT to CWW on the amount set out in paragraph 1 above.

II Binding nature and effective date

- 3 This Determination is binding on CWW and BT in accordance with section 190(8) of the 2003 Act.
- 4 This Determination shall take effect on the day it is published.

III Interpretation

- 5 For the purpose of interpreting this Determination —
 - a) headings and titles shall be disregarded; and
 - b) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.
- 6 In this Determination —
 - a) “2003 Act” means the Communications Act 2003 (c.21);
 - b) “2012 Determination” means a determination made in respect of Ofcom case ref: CW/01078/11/11 in respect of a dispute between BT and CWW regarding BT's charges for Ethernet Services and dated 20 December 2012;
 - c) “BT” means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006;
 - d) “CAT” means the Competition Appeal Tribunal;

- e) “Judgment” means the final judgment given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 1 August 2014;
- f) “Orders” means the orders given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 10 December 2014;
- g) “Relevant Services” means the Ethernet services specified in the paragraph 1 of the 2012 Determination;
- h) “CWW” means Cable & Wireless Worldwide plc (whose registered company number is 7029206) group, including the following CWW companies: Cable & Wireless UK (registered company number 1541957), Cable & Wireless Access Limited (registered company number 4005262), Energis Communications Limited (registered company number 2630471), Thus Group Holdings Limited (registered company number SC192666) and Your Communications Group Limited (registered company number 4171876); and
- i) “Supplementary Judgment” means the supplementary judgment given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 4 December 2014.

Signed by:



Gaucho Rasmussen

Director of Investigations and Enforcement

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

4 May 2017

Annex 4

Determination to resolve the dispute between BT and Sky

Determination under sections 188 and 190 of the Communications Act 2003 (the “2003 Act”) for resolving a dispute between BT and Sky concerning BT’s charges for Ethernet services

WHEREAS—

- (A) on 20 December 2012 Ofcom determined a dispute between BT and Sky relating to BT’s charges for certain Ethernet services (the “2012 Determination”) finding that BT had overcharged Sky for the provision of the Ethernet services specified in the paragraph 1 of the 2012 Determination (the “Relevant Services”) and for the years specified in that explanatory statement to the 2012 Determination, and directed BT to pay Sky, by way of an adjustment of an overpayment for the Relevant Services, the sum of money set out in the 2012 Determination (the “principal overcharge”);
- (B) on 28 December 2012, BT repaid Sky the amount of the principal overcharge as required pursuant to the 2012 Determination;
- (C) on 20 February 2013 BT and Sky lodged appeals with the CAT against the 2012 Determination;
- (D) on 1 August 2014 the CAT gave its Judgment:
- allowing Sky’s appeal against Ofcom’s decision not to award interest on the amount of the repayment of the overcharge; and
 - allowing BT’s appeal in respect of an adjustment in relation to Excess Construction Charges (ECCs) costs;
- (E) section 195(4) of the 2003 Act requires the CAT to remit the decision under appeal to Ofcom with such directions, if any, it considers appropriate for giving effect to its decision;
- (F) on 4 December 2014 the CAT issued a Supplementary Judgment and on 10 December 2014 the CAT issued Orders setting out directions in respect of the Appeals;
- (G) the Orders remitted to Ofcom pursuant to section 195(4) of the 2003 Act the following matters for it to determine, as soon as reasonably practicable, in accordance with the Judgment and the Supplementary Judgment:
- the repayments to which BT is entitled in respect of the exclusion of excess construction costs from its rental costs;
 - the rate of interest payable in respect of BT’s overcharge for Ethernet services;
 - BT’s claim for interest in respect of the repayment on excess construction costs; and

- the total amount payable as between BT and Sky.
- (H) in the explanatory statement accompanying this Determination, Ofcom has set out a revised figure for the principal overcharge for the Relevant Services, taking into account the adjustment which needs to be made in relation to ECCs,
- (I) in the explanatory statement accompanying this Determination, Ofcom has also set out that BT should be required to pay interest on the principal overcharge for the period up to 28 December 2012 and has set out the rates applicable and calculated the amounts due from BT to Sky in respect of this interest.

NOW, therefore, pursuant to the CAT's Orders dated 10 December 2014 Ofcom makes, for the reasons set out in the accompanying explanatory statement, this Determination—

I Declaration of rights and obligations, etc.

- 1 Ofcom gives a direction to BT to pay Sky, by way of an adjustment of an overpayment for the Relevant Services, the sum of £[~~£~~].
- 2 From 29 December 2012, interest at a rate of Bank of England base rate plus 1% compounded annually shall be payable by BT to Sky on the amount set out in paragraph 1 above.

II Binding nature and effective date

- 3 This Determination is binding on Sky and BT in accordance with section 190(8) of the 2003 Act.
- 4 This Determination shall take effect on the day it is published.

III Interpretation

- 5 For the purpose of interpreting this Determination —
 - a) headings and titles shall be disregarded; and
 - b) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.
- 6 In this Determination —
 - a) “2003 Act” means the Communications Act 2003 (c.21);
 - b) “2012 Determination” means a determination made in respect of Ofcom case ref: CW/01052/08/10 in respect of a dispute between BT and Sky regarding BT's charges for Ethernet Services and dated 20 December 2012;
 - c) “BT” means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006;
 - d) “CAT” means the Competition Appeal Tribunal;

- e) “Judgment” means the final judgment given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 1 August 2014;
- f) “Orders” means the orders given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 10 December 2014;
- g) “Relevant Services” means the Ethernet services specified in the paragraph 1 of the 2012 Determination;
- h) “Sky” means Sky UK Limited²⁴⁹ whose registered company number is 02906991, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006; and
- i) “Supplementary Judgment” means the supplementary judgment given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 4 December 2014.

Signed by:

Gaicho Rasmussen

Director of Investigations and Enforcement

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

4 May 2017

²⁴⁹ Previously named British Sky Broadcasting Limited at the time of the 2012 Determination

Annex 5

Determination to resolve the dispute between BT and TalkTalk

Determination under sections 188 and 190 of the Communications Act 2003 (the “2003 Act”) for resolving a dispute between BT and TalkTalk concerning BT’s charges for Ethernet services

WHEREAS—

- (A) on 20 December 2012 Ofcom determined a dispute between BT and TalkTalk relating to BT’s charges for certain Ethernet services (the “2012 Determination”) finding that BT had overcharged TalkTalk for the provision of the Ethernet services specified in the paragraph 1 of the 2012 Determination (the “Relevant Services”) and for the years specified in that explanatory statement to the 2012 Determination, and directed BT to pay TalkTalk, by way of an adjustment of an overpayment for the Relevant Services, the sum of money set out in the 2012 Determination (the “principal overcharge”);
- (B) on 28 December 2012, BT repaid TalkTalk the amount of the principal overcharge as required pursuant to the 2012 Determination;
- (C) on 20 February 2013 BT and TalkTalk lodged appeals with the CAT against the 2012 Determination;
- (D) on 1 August 2014 the CAT gave its Judgment:
- allowing TalkTalk’s appeal against Ofcom’s decision not to award interest on the amount of the repayment of the overcharge; and
 - allowing BT’s appeal in respect of an adjustment in relation to Excess Construction Charges (ECCs) costs;
- (E) section 195(4) of the 2003 Act requires the CAT to remit the decision under appeal to Ofcom with such directions, if any, it considers appropriate for giving effect to its decision;
- (F) on 4 December 2014 the CAT issued a Supplementary Judgment and on 10 December 2014 the CAT issued Orders setting out directions in respect of the Appeals;
- (G) the Orders remitted to Ofcom pursuant to section 195(4) of the 2003 Act the following matters for it to determine, as soon as reasonably practicable, in accordance with the Judgment and the Supplementary Judgment:
- the repayments to which BT is entitled in respect of the exclusion of excess construction costs from its rental costs;
 - the rate of interest payable in respect of BT’s overcharge for Ethernet services;

- BT's claim for interest in respect of the repayment on excess construction costs; and
 - the total amount payable as between BT and TalkTalk.
- (H) in the explanatory statement accompanying this Determination, Ofcom has set out a revised figure for the principal overcharge for the Relevant Services, taking into account the adjustment which needs to be made in relation to ECCs,
- (I) in the explanatory statement accompanying this Determination, Ofcom has also set out that BT should be required to pay interest on the principal overcharge for the period up to 28 December 2012 and has set out the rates applicable and calculated the amounts due from BT to TalkTalk in respect of this interest.

NOW, therefore, pursuant to the CAT's Orders dated 10 December 2014 Ofcom makes, for the reasons set out in the accompanying explanatory statement, this Determination—

I Declaration of rights and obligations, etc.

- 1 Ofcom gives a direction to BT to pay TalkTalk, by way of an adjustment of an overpayment for the Relevant Services, the sum of £[✂].
- 2 From 29 December 2012, interest at a rate of Bank of England base rate plus 1% compounded annually shall be payable by BT to TalkTalk on the amount set out in paragraph 1 above.

II Binding nature and effective date

- 3 This Determination is binding on TalkTalk and BT in accordance with section 190(8) of the 2003 Act.
- 4 This Determination shall take effect on the day it is published.

III Interpretation

- 5 For the purpose of interpreting this Determination —
 - a) headings and titles shall be disregarded; and
 - b) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.
- 6 In this Determination —
 - a) "2003 Act" means the Communications Act 2003 (c.21);
 - b) "2012 Determination" means a determination made in respect of Ofcom case ref: CW/01052/08/10 in respect of a dispute between BT and TalkTalk regarding BT's charges for Ethernet Services and dated 20 December 2012;
 - c) "BT" means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006;

- d) "CAT" means the Competition Appeal Tribunal;
- e) "Judgment" means the final judgment given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 1 August 2014;
- f) "Orders" means the orders given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 10 December 2014;
- g) "Relevant Services" means the Ethernet services specified in the paragraph 1 of the 2012 Determination;
- h) "TalkTalk" means TalkTalk Telecom Group PLC whose registered company number is 07105891, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006; and
- i) "Supplementary Judgment" means the supplementary judgment given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 4 December 2014.

Signed by:

Gaucho Rasmussen

Director of Investigations and Enforcement

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

4 May 2017

Annex 6

Determination to resolve the dispute between BT and Verizon

Determination under sections 188 and 190 of the Communications Act 2003 (the “2003 Act”) for resolving a dispute between BT and Verizon concerning BT’s charges for Ethernet services

WHEREAS—

- (A) on 20 December 2012 Ofcom determined a dispute between BT and Verizon relating to BT’s charges for certain Ethernet services (the “2012 Determination”) finding that BT had overcharged Verizon for the provision of the Ethernet services specified in the paragraph 1 of the 2012 Determination (the “Relevant Services”) and for the years specified in that explanatory statement to the 2012 Determination, and directed BT to pay Verizon, by way of an adjustment of an overpayment for the Relevant Services, the sum of money set out in the 2012 Determination (the “principal overcharge”);
- (B) on 28 December 2012, BT repaid Verizon the amount of the principal overcharge as required pursuant to the 2012 Determination;
- (C) on 20 February 2013 BT and Verizon lodged appeals with the CAT against the 2012 Determination;
- (D) on 1 August 2014 the CAT gave its Judgment:
- allowing Verizon’s appeal against Ofcom’s decision not to award interest on the amount of the repayment of the overcharge; and
 - allowing BT’s appeal in respect of an adjustment in relation to Excess Construction Charges (ECCs) costs;
- (E) section 195(4) of the 2003 Act requires the CAT to remit the decision under appeal to Ofcom with such directions, if any, it considers appropriate for giving effect to its decision;
- (F) on 4 December 2014 the CAT issued a Supplementary Judgment and on 10 December 2014 the CAT issued Orders setting out directions in respect of the Appeals;
- (G) the Orders remitted to Ofcom pursuant to section 195(4) of the 2003 Act the following matters for it to determine, as soon as reasonably practicable, in accordance with the Judgment and the Supplementary Judgment:
- the repayments to which BT is entitled in respect of the exclusion of excess construction costs from its rental costs;
 - the rate of interest payable in respect of BT’s overcharge for Ethernet services;

- BT's claim for interest in respect of the repayment on excess construction costs; and
 - the total amount payable as between BT and Verizon.
- (H) in the explanatory statement accompanying this Determination, Ofcom has set out a revised figure for the principal overcharge for the Relevant Services, taking into account the adjustment which needs to be made in relation to ECCs,
- (I) in the explanatory statement accompanying this Determination, Ofcom has also set out that BT should be required to pay interest on the principal overcharge for the period up to 28 December 2012 and has set out the rates applicable and calculated the amounts due from BT to Verizon in respect of this interest.

NOW, therefore, pursuant to the CAT's Orders dated 10 December 2014 Ofcom makes, for the reasons set out in the accompanying explanatory statement, this Determination—

I Declaration of rights and obligations, etc.

- 1 Ofcom gives a direction to BT to pay Verizon, by way of an adjustment of an overpayment for the Relevant Services, the sum of £[].
- 2 From 29 December 2012, interest at a rate of Bank of England base rate plus 1% compounded annually shall be payable by BT to Verizon on the amount set out in paragraph 1 above.

II Binding nature and effective date

- 3 This Determination is binding on Verizon and BT in accordance with section 190(8) of the 2003 Act.
- 4 This Determination shall take effect on the day it is published.

III Interpretation

- 5 For the purpose of interpreting this Determination —
 - a) headings and titles shall be disregarded; and
 - b) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.
- 6 In this Determination —
 - a) "2003 Act" means the Communications Act 2003 (c.21);
 - b) "2012 Determination" means a determination made in respect of Ofcom case ref: CW/01087/02/12 in respect of a dispute between BT and Verizon regarding BT's charges for Ethernet Services and dated 20 December 2012;
 - c) "BT" means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006;

- d) "CAT" means the Competition Appeal Tribunal;
- e) "Judgment" means the final judgment given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 1 August 2014;
- f) "Orders" means the orders given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 10 December 2014;
- g) "Relevant Services" means the Ethernet services specified in the paragraph 1 of the 2012 Determination;
- h) "Verizon" means Verizon UK Limited whose registered company number is 02776038, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006; and
- i) "Supplementary Judgment" means the supplementary judgment given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 4 December 2014.

Signed by:

Gaicho Rasmussen

Director of Investigations and Enforcement

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

4 May 2017

Annex 7

Determination to resolve the dispute between BT and Virgin

Determination under sections 188 and 190 of the Communications Act 2003 (the “2003 Act”) for resolving a dispute between BT and Virgin concerning BT’s charges for Ethernet services

WHEREAS—

- (A) on 20 December 2012 Ofcom determined a dispute between BT and Virgin relating to BT’s charges for certain Ethernet services (the “2012 Determination”) finding that BT had overcharged Virgin for the provision of the Ethernet services specified in the paragraph 1 of the 2012 Determination (the “Relevant Services”) and for the years specified in that explanatory statement to the 2012 Determination, and directed BT to pay Virgin, by way of an adjustment of an overpayment for the Relevant Services, the sum of money set out in the 2012 Determination (the “principal overcharge”);
- (B) on 28 December 2012, BT repaid Virgin the amount of the principal overcharge as required pursuant to the 2012 Determination;
- (C) on 20 February 2013 BT and Virgin lodged appeals with the CAT against the 2012 Determination;
- (D) on 1 August 2014 the CAT gave its Judgment:
- allowing Virgin’s appeal against Ofcom’s decision not to award interest on the amount of the repayment of the overcharge; and
 - allowing BT’s appeal in respect of an adjustment in relation to Excess Construction Charges (ECCs) costs;
- (E) section 195(4) of the 2003 Act requires the CAT to remit the decision under appeal to Ofcom with such directions, if any, it considers appropriate for giving effect to its decision;
- (F) on 4 December 2014 the CAT issued a Supplementary Judgment and on 10 December 2014 the CAT issued Orders setting out directions in respect of the Appeals;
- (G) the Orders remitted to Ofcom pursuant to section 195(4) of the 2003 Act the following matters for it to determine, as soon as reasonably practicable, in accordance with the Judgment and the Supplementary Judgment:
- the repayments to which BT is entitled in respect of the exclusion of excess construction costs from its rental costs;
 - the rate of interest payable in respect of BT’s overcharge for Ethernet services;
 - BT’s claim for interest in respect of the repayment on excess construction costs; and

- the total amount payable as between BT and Virgin.
- (H) in the explanatory statement accompanying this Determination, Ofcom has set out a revised figure for the principal overcharge for the Relevant Services, taking into account the adjustment which needs to be made in relation to ECCs,
- (I) in the explanatory statement accompanying this Determination, Ofcom has also set out that BT should be required to pay interest on the principal overcharge for the period up to 28 December 2012 and has set out the rates applicable and calculated the amounts due from BT to Virgin in respect of this interest.

NOW, therefore, pursuant to the CAT's Orders dated 10 December 2014 Ofcom makes, for the reasons set out in the accompanying explanatory statement, this Determination—

I Declaration of rights and obligations, etc.

- 1 Ofcom gives a direction to BT to pay Virgin, by way of an adjustment of an overpayment for the Relevant Services, the sum of £[].
- 2 From 29 December 2012, interest at a rate of Bank of England base rate plus 1% compounded annually shall be payable by BT to Virgin on the amount set out in paragraph 1 above.

II Binding nature and effective date

- 3 This Determination is binding on Virgin and BT in accordance with section 190(8) of the 2003 Act.
- 4 This Determination shall take effect on the day it is published.

III Interpretation

- 5 For the purpose of interpreting this Determination —
 - a) headings and titles shall be disregarded; and
 - b) the Interpretation Act 1978 shall apply as if this Determination were an Act of Parliament.
- 6 In this Determination —
 - a) “2003 Act” means the Communications Act 2003 (c.21);
 - b) “2012 Determination” means a determination made in respect of Ofcom case ref: CW/01052/08/10 in respect of a dispute between BT and Virgin regarding BT's charges for Ethernet Services and dated 20 December 2012;
 - c) “BT” means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006;
 - d) “CAT” means the Competition Appeal Tribunal;

- e) “Judgment” means the final judgment given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 1 August 2014;
- f) “Orders” means the orders given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 10 December 2014;
- g) “Relevant Services” means the Ethernet services specified in the paragraph 1 of the 2012 Determination;
- h) “Virgin” means Virgin Media Limited whose registered company number is 02591237, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 1159 of the Companies Act 2006; and
- i) “Supplementary Judgment” means the supplementary judgment given by the CAT in respect of case numbers 1205/3/3/13, 1206/3/3/13 and 1207/3/3/13 and dated 4 December 2014.

Signed by:

GaUCHO Rasmussen

Director of Investigations and Enforcement

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

4 May 2017