COLT response to Ofcom Leased Lines Charge Control
March 2009

1. Introduction and summary of response

This paper contains the response of COLT Telecom (COLT) to Ofcom's consultation on "Leased Lines Charge Control".

COLT would also refer to the response that its industry trade body UKCTA has submitted in relation to the broader questions raised in the consultation and the proposed T1 basket controls. COLT fully supports this response. For the most part this response focuses on COLT's comments regarding the AI basket.

This consultation is critical to the future competitiveness of the UK access market place for next generation Ethernet services. The structure of the controls that Ofcom chooses for the incumbent will indicate how serious Ofcom is about promoting and maintaining a competitive business marketplace in the UK.

Many large customers and associations in the UK are expressing concern at the dwindling level of access infrastructure competitors and lack of supplier choice. This is becoming increasingly critical in the marketplace for data centre outsourcing and data centre connectivity.

COLT believes that the currently proposed Leased Lines Charge Control will be ineffective as ex ante protection against anti-competitive pricing by BT in markets which are important to COLT and UK businesses. The proposed controls would undermine existing competition by:

- Basing new controls on accounts which are not fit-for-purpose
- Failing to put in place the checks and balances to ensure BT is complying with it's cost orientation obligations.
- Providing very flexible baskets where cross-subsidisation and anti-competitive behaviour could result.

The key summary of COLT's response is as follows:

1. COLT believes that WES and BES services should be separated into their own respective baskets.
2. Clarity is required around BT's own use of BES equivalent services and their treatment within the regulated accounts.
3. BT's BES services are highly protifable and BT could cross-subsidise WES charges with the profits.

4. BT's new pricing for WES connections and rentals indicates in the majority of cases that BT is pricing below DLRIC floors and therefore failing to meet it's cost-orientation obligation.
5. The mixing of EBD and BTL services with existing BES services in the AI basket further compounds the risk of cross-subsidisation and anti-competitive behaviour by BT.
6. COLT believes the ancillary charges basket should be structured differently and more clarity given around the services included.
7. There appears to be an over-recovery of Excess Construction Charges in the ancillary charges basket which indicates that BT is not complying with it's cost-orientation obligation.
8. COLT does not agree with Ofcom's proposed treatment of new 21CN services as it allows BT to depart from cost-orientation principles and potentially behave anti-competitively.
9. The starting point of the AI charge control should ensure charges are within proposed ceilings and floors at the outset. COLT does not support a 12 month period of grace.
10. BT should separate out all costs and revenues associated with 21CN components and subject them to a separate charge control regime.
11. COLT urges Ofcom to consider engaging a third party consultant to prepare an independent volume forecast for leased line services.
12. The CVE and AVE ratios are 5 years old and based on old technology. They should be higher for AISBO services.
13. There is a lack of detail and transparency behind the fixed common costs (75%) moving from the TI basket to the AI basket. As a result COLT has no confidence in the reallocation which materially affects the controls.
14. COLT does not support the use of national costs to set charge controls for 34/45Mbit/s services for the non-CELA region for the T1 basket. These should comply with cost orientation obligations.
15. Ofcom should require BT to establish separate controls for discounts, properly cost its services and comply with cost orientation obligations.

2. Background to the response

The treatment of BT's PPC services in BT's regulatory accounts has been contentious to industry for a number of years. Ofcom (and its predecessor, Oftel) have repeatedly expressed concern relating to the treatment of these services in regulatory accounts. In the last 12 months these concerns were confirmed when BT chose to restate its 2006/7 results for PPC products to reflect a net adjustment to revenues of -£143m.

At the same time a number of BT's customers of PPC services submitted disputes to Ofcom relating to BT's pricing, claiming that BT had been in breach of its cost orientation obligations for certain PPC services. As yet these disputes remain unresolved by Ofcom.

It was against this background that Ofcom initiated its Leased Line Charge Control consultation with a view to, inter alia, setting a price control for wholesale leased line services for the period 2009 to 2013.

As Ofcom is aware, COLT has been in correspondence and dialogue regarding the newly proposed charging for WES and WEES services under the AI basket proposals.

A written response and supporting evidence was submitted in response to Ofcom's consultation document on "Notification of a proposal to give consent to affect the operation of BT's price notification requirements". In this response COLT disagreed that a waiver should be granted to BT.

3. General comments regarding the consultation

COLT wishes to highlight further section "9 General comments on the Consultation Document" of the UKCTA response in which the document raises the following points:

- Concerns that BT's Regulatory Accounts are not fit for purpose
- Evidence suggests there are still fundamental problems with BT's regulatory accounting process.
- There is insufficient detail or transparency in relation to BT's costs of Ofcom's costing model to enable stakeholders to fully assess the proposals.
- Reliable and robust calculations of cost floors and ceilings have not been produced for setting the proposed charge controls.

We would remind Ofcom of the cost orientation obligation that exists upon BT to ensure that charges are reasonably derived from the costs of provision. It is difficult to see, given the evidence in the report supporting UKCTA's response, how the proposed controls for the Leased Lines marketplace are fit-for-purpose to effectively regulate a market for the long-tem benefit of customers.

UK infrastructure competition is critical to ensuring a healthy telecommunications marketplace for the future. Although only a few infrastructure competitors to BT remain, they still provide important choice to customers. In the long term, the market will only be sustainable if infrastructure competition prevails, otherwise Ofcom will be forced to regulate this market indefinitely.

4. COLT responses to questions regarding the A1 basket proposals

Question 5.1 Do respondents agree with Ofcom's proposal of a single AI basket with separate sub-caps of RPI-0% on each of the sub-baskets of WES and BES services? Do respondents also agree with the sub-cap of RPI-0% on each of the sub-baskets of connections and rentals?

COLT does not agree with Ofcom's structure of the AI basket. It believes that BES and WES services should be placed in separate baskets.

WES/WEES and BES services are used very differently and address different customer groupings in different markets:

- WES offers wholesale Ethernet access to individual business customers from 10Mbit/s to 1 Gigbit/s (purchased by medium and large-sized businesses)

- BES is a tightly defined service, which is currently primarily used by local loop unbundlers to provide backhaul from BT's exchange to the unbundler's own network. Other potential uses of the service are prohibited by BT:

"The BES Service may not be used for connection:

(a) between the Communications Providers' sites or Third Party CP sites unless one or both sites is a Co-location, Netlocate or BT Locate of the Communications Provider or Third Party CP;

(b) between the Communication Provider's network and an other communications provider's network, except where the connection is between a Communication Provider's Co-location, Netlocate or BT Locate facility and another communication provider's network (not in the same exchange);

(c) from an End User's Site to another communications provider's network; or

(d) of two or more End Users' Sites;

(e) from Core Node to Core Node;

(f) from Core Node to a Communication Provider site;

(g) from Core Node to a Third Party CP site;

(h) for the provision of interconnect services;"[1]

Ofcom is proposing to include all core AI connection and rental services in the main AI basket – only accommodation services are excluded. There are a number of arguments for excluding BES services from AI basket

- BES circuits and WES/WEES are used by different customers for different types of services. Mixing the two in one basket could provide BT with the potential to gain an unfair competitive by pricing aggressively in more competitive areas (ie WES/WEES) and recovering a greater proportion of common costs from services facing less competition (ie BES).

- The network costing of BES and WES is based on different network components and BT's regulatory accounting process disaggregates BES network costs from WES network costs at an early stage in the cost allocation process.

- Current pricing and cost recovery suggests that the profitability of the two services is very different, reflecting the different market conditions facing the two services.

WES "This service captures the costs of the electronics at either end of the point to point fibre. These fibre costs are within the equivalent rentals component."

[1] BT's BES Product Handbook http://www.openreach.co.uk/orpg/products/bes/downloads/bes_product_handbook_issue7-6.pdf

BES: “The product provides a hub and spoke configuration, this service captures the electronics costs, the associated fibre and duct costs are within the equivalent rental component.”[2]

COLT therefore believes there is no need to group these services in one basket.

BT’s use of BES services (internal use)

BES services are only sold to external customers and not used internally. We show that they are highly profitable later on in this response.

It is clear that BT does use its own network for backhaul services, but it is not clear how BT’s own use of ‘BES equivalent services’ are costed or priced. In order to comply with fundamental regulatory principles of equivalence, non-discrimination and transparency, Ofcom should establish how BT’s own use of BES equivalent services is treated in the Regulatory Accounts. BT should be required to price and cost them on the same basis as for external customers.

We note that in Ofcom’s current consultation on local loop pricing, a similar issue arose: BT’s Regulatory Accounts for Wholesale Local Access did not include any internal use of MPF or SMPF equivalent services. In its modelling of the costs for external services however, Ofcom included all internal services, spreading those costs previously allocated only to external sales over all sales- internal and external.

Ofcom should consider whether such an approach would further increase the profitability of BES services and the implications for AISBO pricing general.

BES is highly profitable

BT faces very little competition for provision of BES services, and as a result is able to generate significant returns. The table overleaf shows average 2007/8 prices and costs for BES services taken from BT’s regulatory accounts. The price reductions introduced in January 2009 are also shown.[3]

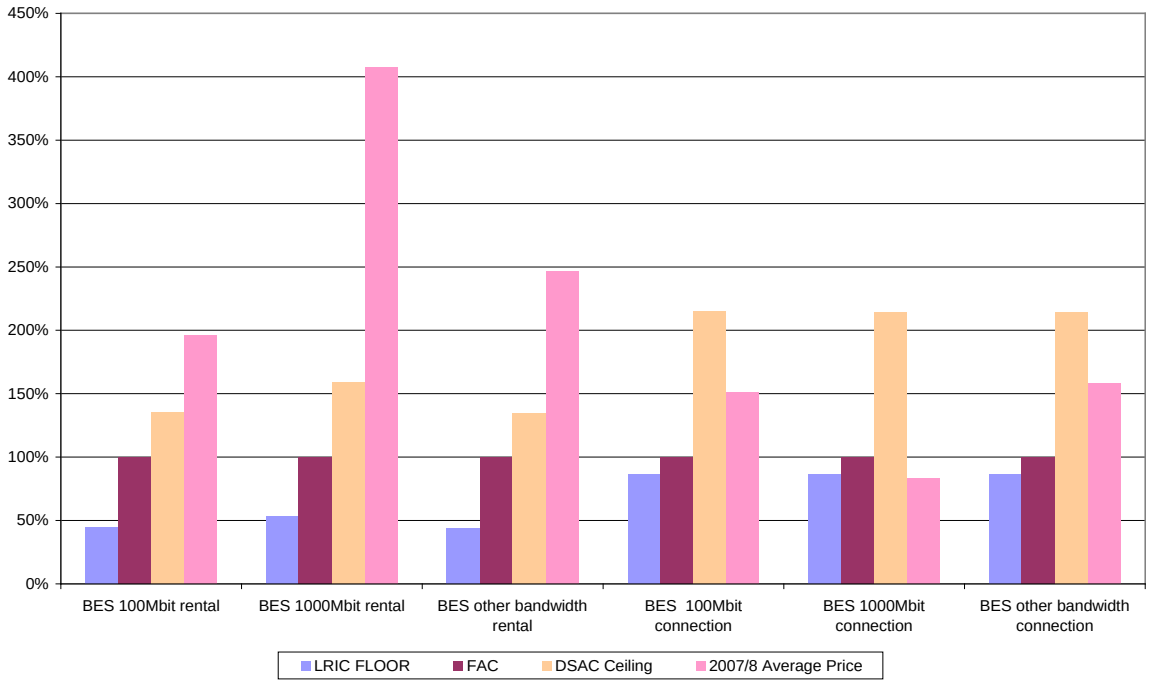
The table clearly demonstrates that BT is able to charge well above all the Fully Allocated Cost (FAC) of most BES services and above standalone cost for rental services. Our analysis further on shows how BT is pricing below FAC and DLRIC floors for a number of WES connections and rentals.

This clearly supports a view that BT faces very little competition in the BES market. As BES and WES are in the same basket, BT can cross-subsidise WES charges with profits from BES.

[2] BT’s DAM p599, 600

[3] 2009 prices may be understated as we have applied the maximum price reduction per service type rather than the average, as insufficient breakdown of revenues by type of service is provided.

BES Prices and Costs (Est)



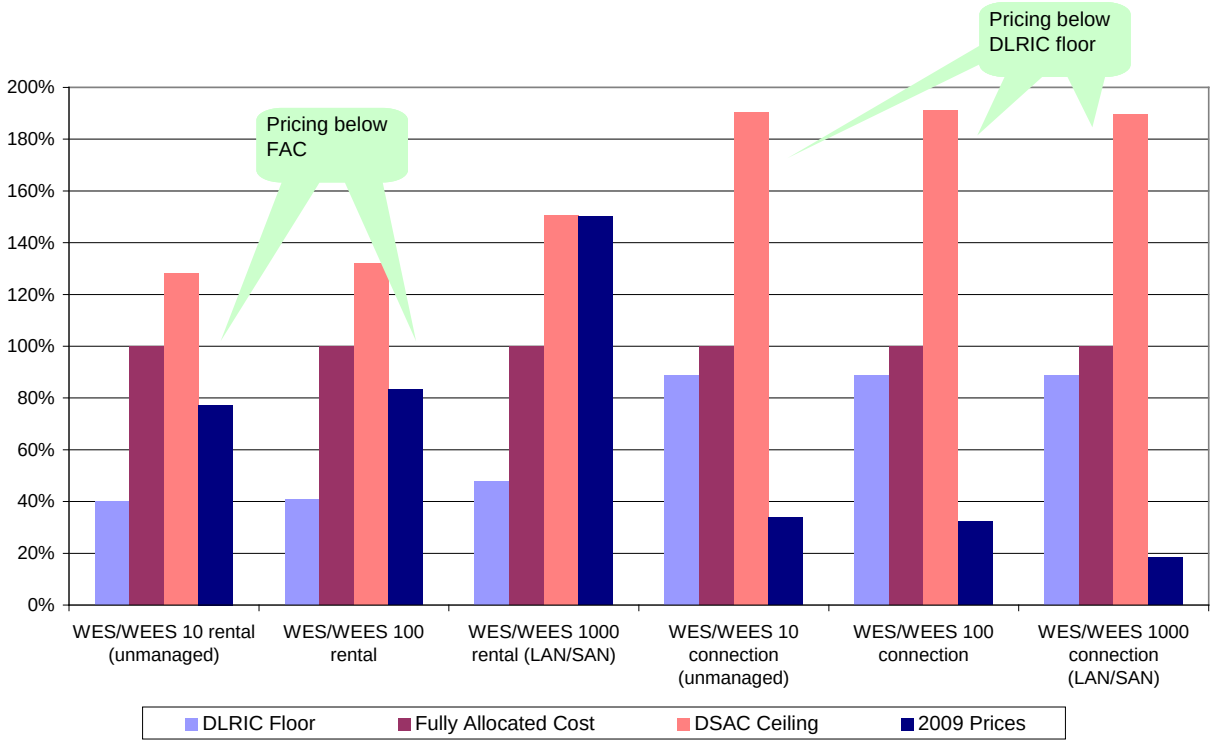
Source: BT's 2007/8 regulatory Accounts, RGL analysis

BT's ability to price differently between WES and BES customers is illustrated by the difference in connection charges. The level of costs underlying the connection services appear to be directly comparable.

Even after taking into account the most recent price increases, the majority of BT'S WES service will remain above the most recent cost data set out in BT's 2007/8 Regulatory Accounts.

Current (March 2009) WES prices compared to 2007/8 costs (unadjusted) are shown overleaf.

WES 2009 Prices and 2007/8 Costs shown as % of Fully Allocated Cost



Source: BT Regulatory Accounts, RGL analysis[4]

COLT has already submitted further evidence to Ofcom of BT pricing below cost for WES services highlighting a failure to comply with it's cost orientation obligation.

Treatment of new services

The proposed treatment of new services significantly weakens the effectiveness of the charge control as an ex ante protection against anti-competitive pricing.

We are concerned that the mixing of new EBD and BTL services with existing BES services in the AI basket further increases the risks that:

- BT is given an opportunity to 'game' the regulatory process by using excessive returns in some products (in particular BES and their replacements) to offset predatory pricing on other more competitive services (such as WES and WEES).

- The use of forecasts and the complexity of the proposed calculations of average prices for all the services will mean that monitoring of the charge control will be difficult in practice.

[4] Not all variants of WES services are shown, but other variants (eg managed services) show similar patterns of cost recovery

Anti-competitive behaviour and failure to comply may only be detected long after the event. As a result the charge control will be ineffective as ex ante protection against anti-competitive pricing by BT in these important markets.

Question 5.3. Do respondents agree with Ofcom's proposal to include ancillary charges in a basket of their own subject to RPI-0%?

COLT wishes to see this basket structured differently to Ofcom's proposals.

We note that from the BT Report and Accounts ancillary services are one area where costs seem to be increasing. We believe much of this is being driven by Excess Construction Charges levied against new connections to WES services. We understand that BT may allow an additional 15% on top of WES connection charges for new connections. We would therefore expect such charges to form part of the connection costs of the WES services covered by sub caps in the AI basket and removed from this basket.

It is also unclear to COLT exactly which services are included in this basket. We believe the lack of clarity on services contained within this basket and potential flexibility afforded the incumbent raises further risks of anti-competitive behaviour.

COLT's concern is again that BT could use this basket to cross-subsidise connection charges and work around the existing caps and sub-caps on the AI basket connection charges.

Excess Construction Charges

BT's Regulatory Accounts do not separate out the costs for Excess Construction Charges – they are included in the costs shown for connection and rental services. Revenues are separately disclosed, however we understand that the majority of charges are associated with WES services. If these costs are divided into the external WES revenues from connection in the 2007/08 regulatory accounts, Excess Construction charges could account for nearly 33% of external WES connection charges.

Excess construction charges distort BT's AISBO core services profitability and provide a potential opportunity for anti-competitive cross subsidies

Ofcom were not able to identify the relevant costs for these services, but assumed that for 2006/7 they were equivalent to 1.8% of revenues, on the basis that this was the assumption used in their analysis of TI costs.[5] There does not appear to be any justification for this assumption.

However, the implied costs for Excess Construction Costs in 2006/7 of £11m, compared to revenues of £16m implies an over recovery of costs of £5m. This represents a *prima facie* case that BT is failing to comply with its cost orientation obligations for these services.

COLT therefore believes that Ofcom should require BT to separately cost Excess Construction Charges, comply with the underlying cost orientation obligation for these services and provide full transparency regarding the costs.

[5] Leased Lines Charge Control Consultation document page 185

Question 5.4 Do respondents agree with Ofcom's proposal not to take the RAV adjustment into consideration when adjusting Openreach's base year costs for 2006/07?

No comment

Question 5.5 Do respondents agree with Ofcom's proposal to exclude 21 CN "direct" costs from Openreach's base year costs for 2006/07?

We are concerned that the introduction of new 21CN based infrastructure will provide BT with an opportunity to significantly harm competition in the retail business connectivity markets.

In allowing BT to continue to price services based on the costs of old technology, whilst it uses lower cost 21CN networks, Ofcom will, in effect, allow BT to depart from a 'cost orientation' regime. This represents a fundamental risk to the competitiveness of downstream retail markets in a number of ways:

- BT can subsidise loss making retail services;
- Competitors such as COLT face margin squeeze pricing by BT;
- It will be very difficult to determine whether or not BT is engaging in predatory pricing, or excessive pricing, given the clouding of the proposed basis for measuring cost recovery implied by the charge control.

In our view Ofcom must ensure that BT's ability to unfairly benefit from the introduction of 21CN is countered by requiring BT to separate out all costs and revenues associated with 21CN components and subject them to a separate charge control regime.

This approach need not stifle investment, efficiency or innovation – it is necessary to protect the currently fragile business connectivity markets in the UK. A failure by Ofcom to properly address this issue now could have a severe and negative impact on the ability of other operators to invest and compete in these or similar markets in the future.

Question 5.6 Do respondents agree with Ofcom's proposal to amend debtors when adjusting Openreach's base year costs for 2006/07?

No comment

Question 5.7 Do respondents agree that there should be no further one off adjustments to the start charges for services in scope of the AI basket and that prices should be brought within the DLRIC floors and DSAC ceilings within the 12 months of implementation?

COLT does not fully agree with Ofcom's proposal. We believe that the starting point of the charge control should ensure that the charges are within the proposed ceilings and floors at the outset.

The current Leased Lines Charge Control has been in place since 2004 so BT has already had five years to meet it's cost-orientation obligations which is proving problematic. COLT

therefore disagrees with allowing BT an effective 12 month grace period during which to effect price controls that currently show an under or over-recovery of costs.

COLT identified (above) that for most WES services, BT is pricing outside of the relevant LRIC floors and ceilings calculated in the 2007/8 Regulatory Accounts. This provides prima facie evidence that BT is not compliant with its underlying cost orientation obligations for these services. Ofcom should require that BT adjusts its prices immediately to bring them within the relevant floor and ceiling, and not, as currently proposed, within 12 months of the start of the charge control period.[6]

Granting BT 12 months to bring itself into line with its cost orientation obligations will enable it to continue to unfairly compete against its competitors.

The opportunity for BT to cross-subsidise should be eliminated. Anti-competitive cross subsidy can exist where one service is shown to be selling below marginal (or incremental cost) and losses on those services are being financed by excessive profits on other services. This is exactly the issue with WES and BES services.

Two measures are required to prevent BT cross subsidising WES services with profits from BES service:

- BES and WES products should be placed in separate baskets
- Pricing for all WES and BES services should be brought within the relevant floors and ceilings with immediate effect.

Question 5.8 Do respondents agree with the volume forecasts used in the LLCC model for AI basket of services? If not, please provide your views on the future volume forecasts of wholesale services in scope of the charge control.

COLT is concerned that Ofcom appears to be relying on BT's internal estimates for volumes. In the context of a charge control, BT has an obvious incentive to manipulate forecast volumes, in order to justify higher or lower prices. Ofcom should satisfy itself that the volume forecasts are reasonable.

We would therefore urge Ofcom to consider engaging a third party consultant to prepare an independent volume forecast for leased line services, based on the views of end users.

Question 5.9 Do respondents agree with our proposed forward looking efficiency range of 1% to 3% to apply to services within the scope of the AI basket?

No comment

Question 5.10 Do respondents agree with the range of WACC proposed for services within scope of the AI basket?

A key input into the calculation of WACC is the risk-free rate of return, which is dependent on inflation. Clearly this is a difficult estimate to make in the current economic climate and we are

[6] Para 5.49 Leased Line Charge Control document

concerned that, whatever assumption is made by Ofcom, BT is not provided with an opportunity to make excess returns for the duration of the charge control because its actual cost of capital is below that assumed in the charge control.

Question 5.11 Do respondents agree with our proposed AVEs/CVEs for Ethernet services?

We are concerned that neither BT nor Ofcom appear to have prepared current AVE and CVE estimates for AISBO services. Ofcom is proposing to use the same ratios as prepared for TISBO services in 2004. The proposed AVE and CVE ratios are therefore 5 years old and were prepared for a different technology. Further, it is not clear what the basis for those ratios in 2004 was – there is simply a reference to the same factors being used in 'other charge controls'[7].

In our view, it would be reasonable to expect CVE and AVE ratios to be higher for AISBO services than for other services. AISBO services should have better economies of scale than other services.

COLT is disappointed that Ofcom has not properly investigated this important assumption.

Question 5.12 Do respondents agree with our proposed use of the average historic five year trend in the real asset price changes when forecasting the costs of AI services?

No comment

Question 5.13 Do respondents consider that we should accept KCOM's commitment to reduce low bandwidth AISBO prices by RPI-16% a year over the period to 2012?

No comment

Question 6.1 Do stakeholders agree with our proposed charge control formulae for AISBO services? We would welcome stakeholder views on our proposed mapping of existing products on to Openreach's new products set.

Section A 9.86, page 205 of the LLCC consultation claims that the re-allocation of fixed common costs results in 75% of the fixed costs being re-allocated from the T1 basket to the AI basket. This is a staggering figure which massively changes the basis of the charge controls.

The calculations lack any detail or transparency and COLT can only wonder how plausible they are. We have no confidence in this figure as part of the basis for a charge control.

Again we are concerned that the proposed approach will provide BT with an opportunity to price in an anti-competitive manner by allowing it to price outside of competitive cost levels. BT

[7] Partial Private Circuits Charge Control Consultation document, Ofcom, 24 June 2004 Para 4.24

has a commercial incentive to take advantage of the flexibility it is afforded and it is important that Ofcom ensures this is prevented.

In our view all costs and revenues for new services and costs and revenues for 21CN based services should be separated into baskets. BT should be required to separately calculate revenues and costs for each service/technology mix and comply with its underlying cost orientation obligations on a service by service basis.

A failure to disaggregate services and require compliance with the underlying cost orientation obligations will, in our view, provide BT with the opportunity to engage in harmful, not healthy, pricing to the detriment of competition.

Question 6.2 Do stakeholders agree that the required notification period should be waived in respect of the proposed starting charge adjustments to some TI services?

No

Question 7.1 Do respondents agree that the charge controls on AISBO services should run from the introduction of the new proposed controls to 30 September 2012?

Yes

5. COLT responses to specific questions regarding the TI basket proposals

Q3.10 Do respondents agree with the use of national costs to set the charge controls for the 34/45Mbit/s services for the non-CELA region?

COLT does not agree with Ofcom's proposals.

Ofcom is proposing to apply national cost data to assess prices in the UK outside of the Central and East London Area.

Ofcom's argument for using national cost data is that BT does not currently prepare cost data on a geographic basis and so does not know what its costs are for the UK excluding CELA. As Ofcom itself says:

"In principle, the preferred option would be to model BT's costs based on actual geographic data for those costs in the CELA and non-CELA areas."[8]

Ofcom then argues that it is willing to divert from this preferred option because it would be difficult to establish robust geographic cost data.

In COLT's view such an approach is unacceptable. BT has an obligation to prepare the relevant cost information to comply with its cost orientation obligations. The fact that this may

[8] Para 3.146 Consultation Docu
ment

not be straightforward does not provide a valid reason for non-compliance. We are sure that if BT itself wanted to prepare such data, it would be able to do so; the fact that it has not, in itself, suggests that BT has a commercial interest in using the national cost data.

Where, as is the case here, and recognised by Ofcom, that there are risks to competition in deviating from the preferred option, Ofcom should insist that BT prepares the geographically de-averaged prices needed to ensure compliance with charge controls and that BT prices in a cost oriented manner in respect of those geographic costs.

Q3.12 Do respondents agree with our proposed approach to discounts, in particular the proposed treatment of geographic and term discounts under the charge control

Ofcom is proposing to allow BT the ability to set differential charges between different geographic areas and also to allow term discounts.

Geographic pricing, Ofcom argues, will allow BT to better respond to competition. In COLT's view this measure will simply allow BT to significantly harm competition by driving prices down to a level against which its competitors cannot compete – i.e BT will be provided with an opportunity to engage in harmful predatory pricing.

Ofcom has found BT to have SMP in these areas, and therefore by definition a degree of monopoly power. It is not BT that needs protecting, it is its competitors. If Ofcom believes that there really is a risk of competition being harmed by BT's inability to compete, it should establish separate controls for those areas, require BT to properly cost its services in those areas and, where appropriate comply with a cost orientation obligation. Only this approach will ensure that BT is not allowed to price in a discriminatory and predatory manner.

Similarly, we are concerned that allowing BT to offer term discounts will simply lead to harm in the market place. In our view, BT can be expected to take advantage of this flexibility to price in a way that does direct harm to competition. Ofcom's overall cost recovery arguments will not prevent BT from pricing anti-competitively. We should not have to rely on *ex post* competition law remedies to deal with our concerns in this area – by then the damage will be done.

Ofcom has deemed it necessary to set up a charge control regime to protect competition in these fragile markets. It should not then give BT the means to drive its competitors out of business.

End