



BSKYB'S COMMENTS ON BT'S RESPONSE TO THE DRAFT DETERMINATIONS TO RESOLVE DISPUTES BETWEEN BT AND VARIOUS COMMUNICATIONS PROVIDERS REGARDING BT'S CHARGES FOR CERTAIN ETHERNET SERVICES

SUMMARY

1. BT's response to the draft dispute determination does not raise any new issues. In fact, BT's response only serves to reinforce Sky's view that BT has breached its cost orientation condition and that Ofcom should calculate the overcharge by reference to Fully Allocated Costs ("**FAC**") instead of Distributed Standalone Cost ("**DSAC**"). Ofcom should require BT to repay the providers the overcharge quickly and with interest.
2. The cost orientation condition is clear in that it requires BT to ensure that its prices are cost oriented and to demonstrate this to the satisfaction of Ofcom. Any perceived lack of clarity as to how this is achieved is no defence and, in any event, there was clarity as to how Ofcom may approach a cost orientation assessment. If there were any uncertainty, it could have erred on the side of caution when setting its prices but it did not do this.
3. Sky notes that BT has finally accepted that the cost orientation applies to each and every individual charge and not aggregated charges. However, BT still asserts that connections and rentals should be viewed in aggregate because they are always bought together and in the same proportions. This is plainly wrong and it remains important that the prices of both connections and rentals are cost oriented by themselves otherwise distortions will occur.
4. Ofcom should consider carefully the consequences of allowing BT's proposed "corrections" and adjustments outlined in its response. BT is uniquely placed to be able to identify within its own cost data (to which other stakeholders do not have access) adjustments that would work in its favour to reduce the level of overcharging.
5. Further, allowing some of these adjustments would involve reallocating costs from other markets into AI symmetric broadband origination ("**AISBO**") or between different AISBO services. This would undermine Ofcom's previous work in setting charge controls and assessing compliance to cost orientation in other cases. Other adjustment proposals made by BT (in relation to 21CN and Payment Terms) are without merit.
6. Sky has already addressed the issue of nascence and the perceived level of cost uncertainty in its own response to the draft dispute determination. BT argues that the Ethernet market was highly volatile and unpredictable but, Sky's experience as a large purchaser of AISBO services does not accord with this portrayal.
7. BT overcharged on a wide variety of Ethernet services, by a significant margin and over a number of years. Its costs were relatively predictable and it should have had access to regular, monthly cost data by which to monitor its compliance. In light of these factors, Sky

does not think it is appropriate to exclude from an assessment of compliance with the cost orientation condition any services that only exceeded DSAC for one year.

SECTION 1 – OFCOM SHOULD RESOLVE THIS DISPUTE QUICKLY, BY REFERENCE TO A FAC-BASED COST STANDARD AND AWARD INTEREST

8. Having reviewed BT's submission, Sky does not consider it necessary to alter the substance of its response¹. On the contrary, Sky considers that BT's response provides further support to Sky's position that:
 - a) BT has breached the SMP Condition HH3.1²;
 - b) *"..it is the innocent counter-party purchasers of BES and wholesale extension services ("WES") that have suffered adversely as a consequence of: (i) BTs various breaches of its regulatory obligations, and (ii) the delay in the repayment of the overpayment."*³; and
 - c) Ofcom should hold BT to its regulatory obligations by resolving these disputes promptly, calculating the overcharge by reference to FAC (because without off-setting under-recovery of common costs elsewhere, DSAC would allow BT to significantly over-recover its common costs) and require BT to repay the overcharge with interest.

9. In the light of the above, Sky does not consider it necessary to provide a blow-by-blow analysis of BT's submission. Instead, Sky has adopted a high-level approach to its comments on BT's submission. Before setting out its comments, Sky wishes to make the following points:
 - a) There is a significant cost to Sky (and a benefit to BT) that flows from any delay to the resolution of the dispute, save that the cost to Sky can be mitigated in the event that BT is required to pay to Sky the appropriate level of interest on the outstanding sums. Sky has no doubt that Ofcom is diligently progressing the resolution of the dispute.⁴ It will, nevertheless, take further time for Ofcom to consider the various responses to the responses (including this one). Such further delay will continue to materially benefit BT and materially cost Sky.
 - b) BT does not specifically deal with the issue of whether or not interest should be payable on the amount of the overcharge. Any submission that BT makes in respect of interest - having now had sight of both Sky's and TalkTalk's responses - should be considered carefully by Ofcom given BT's previous silence on the issue.

¹ Response of BSKyB to Ofcom's Draft Determination to resolve a dispute between, amongst others, BT and BSKyB regarding BT's charges for Ethernet services, dated 20 April 2012.

² It is also clear that BT has also breached its obligations to provide Ethernet services on fair and reasonable terms and for accounting transparency.

³ §1, Response of BSKyB to OFCOM's Draft Determination to resolve a dispute between amongst others, BT and BSKyB regarding BT's charges for Ethernet services

⁴ [CONF]

SECTION 2 - BT'S ASSERTIONS OF A LACK OF CLARITY AS TO ITS REGULATORY OBLIGATION TO ENSURE THAT ITS PRICES WERE COST ORIENTED

10. While BT concedes that overcharging has occurred, it makes much of what it considers are mitigating circumstances. In particular, BT emphasises an alleged lack of clarity as to exactly how it should comply with the cost orientation condition and difficulties it claims (without presenting any evidence) it had in forecasting accurately its costs. Sky deals with this latter point in the Nascence (Section 5) later on in this document.
11. Sky contends that, in the circumstances of this case, BT is wrong to rely on a lack of clarity as mitigation for the following reasons.
12. First, the compliance burden falls squarely upon BT. Even if there were a lack of clarity (which Sky does not consider to be the case), it is incumbent upon the regulated firm to arrive at a considered view as to how to comply with its formal obligations. This is no different to any other condition or law that applies to BT or more generally to other communications providers. Uncertainty as to the method by which to achieve compliance is no defence.
13. BT is a large, well-resourced company that has been found to have significant market power (“SMP”) in several markets. The resultant imposition of SMP conditions cannot be taken lightly because of the significant risk of economic harm that could arise should these conditions be breached. Therefore, if BT were uncertain as to its compliance, it should have acted quickly to resolve that uncertainty. Moreover, BT cannot reasonably infer from Ofcom’s previous silence that such silence equates to an approval by Ofcom that BT’s prices were cost oriented.
14. In fact, if there was any doubt as to the need for BT to arrive at a view as to what constitutes cost oriented prices, one merely needs to refer back to the wording of Condition HH3.1 which explicitly requires BT “...to demonstrate to the satisfaction of Ofcom...”⁵ that its prices were compliant. This goes further than some other conditions in requiring BT to proactively demonstrate its compliance. A failure by BT to take a considered view as to the appropriate level of pricing in order to be cost oriented to the satisfaction of Ofcom is, in itself, a breach of Condition HH3.1.
15. Second, far from there being a lack of clarity, it was quite clear that BT’s pricing was far in excess of the relevant cost benchmarks which are likely to be relevant when assessing compliance with Condition HH3.1. The Network Charge Control Guidelines from 1997 and 2001 explained that Ofcom would assess cost orientation by reference to Distributed Long Run Incremental Cost floors and DSAC ceilings while Ofcom typically sets price caps by reference to FAC. BT includes these three cost measures in its Regulatory Financial Statements (“RFS”) and does not produce any other alternative unit cost measures.
16. In this context, BT’s confession that “*In truth the calculation of DSAC’s received too little attention by BT...*”⁶ shows a disregard for Ofcom’s guidance and its own accounting transparency obligation. BT effectively chose to ignore the most likely cost measure by which Ofcom would make an initial assessment of cost orientation.

⁵ §2.12, *Draft Determination to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT’s charges for Ethernet services.*

⁶ §232, BT’s response to Ofcom’s Draft Determination to resolve a dispute between, amongst others, BT and BSkyB regarding BT’s charges for Ethernet services, dated 20 April 2012.

17. Indeed, while BT attempts to portray a lack of clarity as to the appropriate cost measures that may be relied upon, it also asserts that DSAC allows “..BT the *‘intended’ bounded flexibility.*”⁷ So, it is inconsistent for BT to argue a lack of clarity while, in the same breath, publishing DSAC data in its RFS, supporting DSAC as a cost ceiling but pricing well above that level.
18. In Sky’s view – as well as in BT’s and the Competition Appeal Tribunal’s – DSAC should not be applied mechanistically. Prices that are either above or below this level could be construed as excessive. Sky considers that, in the case of Ethernet, prices set at the level of DSAC would be excessive unless there was some off-setting under-recovery of relevant common costs elsewhere. Not only is there no evidence of such efficient off-setting, but the relative demand elasticities of the retail services that ultimately share the relevant common costs would have to be infeasibly variant to each other to warrant such a high mark up (to DSAC).
19. BT, on the other hand, is concerned with retrospectively justifying prices that were in excess of DSAC. Either way, Condition HH3.1 requires BT to demonstrate that its pricing is compliant. There is nothing in BT’s response which explains why pricing above the level of DSAC is appropriate nor has it provided an alternative level of pricing above DSAC by which to assess cost orientation in these circumstances. On the contrary, it has set out in its response that – in its view DSAC – is the appropriate ceiling.
20. Even if one were to consider that there was some uncertainty as to the exact cost ceiling by which compliance with the cost orientation condition would be assessed, one would expect, given the seriousness of a breach of its SMP conditions, BT to have erred on the side of caution by ensuring that its prices were well below the DSAC ceiling for each and every charge. In fact, BT would have been aware that Ofcom may require repayments back to the level of FAC due to a breach of the cost orientation condition⁸. However, BT did not do this. Nor did it seek to demonstrate why prices in excess of DSAC were appropriate in these circumstances.
21. BT’s response loses sight of the fact that DSAC represents a possible ceiling for prices. BT is able to price well below DSAC and will not lose money. In fact, if aggregate prices remain above FAC it is likely that it will over-recover its common costs.
22. Third, if BT considered that there was a lack of clarity in how the cost orientation condition would apply, why did it claim - [CONF] - that its pricing was compliant with the cost orientation condition?⁹

SECTION 3 - WHETHER TO AGGREGATE CONNECTIONS AND RENTALS WHEN ASSESSING COST ORIENTATION

23. It is welcome that BT has now conceded that it is inappropriate to aggregate the revenues and costs of all Ethernet services when assessing whether prices are cost oriented:

“BT is not arguing for the aggregation of different bandwidths, or Main Link and other services, or BES and WES.”¹⁰

⁷ §229 BT, *op cit.*

⁸ *Resolution of a dispute between Energis and BT relating to BT’s charges for WLR ISDN2 from 28 November 2003 until 1 October 2004*- <http://stakeholders.ofcom.org.uk/consultations/energis-bt/resolution/>

⁹ [CONF]

¹⁰ §ES12, BT, *op cit.*

24. However, BT maintains that aggregation is still required in the case of connections and rentals because:

“...there is a single service for which both a connection charge and a rental charge are published.”¹¹

BT, however, makes a fatal error in supporting this position.

25. First, the wording of Condition HH3.1 is clear in that “each and every charge offered” should be cost oriented and, as such, both of these charges should reflect their respective costs and should not be looked at in aggregate as BT would prefer.

26. Second, the basis for requiring each charge to be cost oriented is apparent. Without such protection, market distortions could occur. Should BT set its connection charges too high but allow a lower level of rental prices as a counterweight, then demand could be reduced for those unwilling to pay the high upfront charges. This in turn may lead to inefficient consumption and investment. Equally, those willing to pay the higher connection costs and lower rental prices, may be “locked in” to the SMP operator thus reducing entry incentives for other operators. Equally, low connection prices and high rental prices may result in the opposite distorting effects.

27. Third, while BT supports its view by asserting that connections and rental are always bought together and in the same proportions¹², this is not true. Ofcom has already pointed out that connections and rentals are not purchased in the same proportions. Specifically, because communications providers will rent circuits for differing durations, the proportion of connection costs to rental costs will be different. BT alleges, however, that there are:

“...on the most part, only small differences between CPs in terms of the average lives of the circuits that they have bought from Openreach.”¹³

28. While it is not possible to comment on the BT analysis that underpins this assertion, it is apparent that connections and rentals are bought in different proportions:

- a) BT itself admits that connections and rentals are bought in different proportions:
- b) Those operators with qualifying Local Area Network extension services (“LES”) circuits were able to migrate them to BES when Openreach first launched Ethernet services. These circuits, therefore, did not attract a BES connection charge and were not bought in the same proportion as rentals ([CONF]);
- c) As operators can upgrade and downgrade between different Ethernet bandwidths and can migrate BES and WES services to 21CN variants such as EAD and EBD, it is clear that there will be variant circuit tenures and, hence, rentals will not be held in static proportions to connections.
- d) BT claims that any differences in these proportions are

¹¹ §ES12, BT, *op cit*.

¹² §ES10 - §ES16, BT, *op cit*.

¹³ §ES14, BT, *op cit*.

“...largely a product of the different stages they [BT’s Ethernet customers] had reached in rolling out their networks...”¹⁴

But this implies that, ultimately, over the long term all operators will rent Ethernet circuits from BT for the same length of time and in the same proportions to connections. This is not the case. LLU operators like Sky and TalkTalk continue to expand their LLU networks and require more Ethernet circuits as a result. This is not the case for LLU operators who are not expanding their networks or who have exited the LLU market (such as Orange).

29. In light of these factors, it remains entirely appropriate to assess cost orientation for connection and rental prices separately. Even if one were to agree that aggregation were merited (which Sky does not), then this merely strengthens the case further for a FAC based cross-check as both BT’s connection and rental prices were in excess of FAC and, without off-setting elsewhere, it would still be able to over-recover its common costs.

SECTION 4 – PROXIES, ADJUSTMENTS AND ERRORS

30. In its response, BT argues that Ofcom should make a further set of adjustments and corrections to the DSAC data in order to arrive at a better view as to the level of costs.

31. As much of this information is redacted and derived from BT’s own models (to which Sky does not have access), it is not possible for Sky to comment fully on the appropriateness of these adjustments and corrections. However, there are several reasons why it would be inappropriate for Ofcom to accept BT’s proposals:

- a) Only BT has access to its cost models in order to identify further errors or methodological changes. As a result, there is an inherent asymmetry and bias in relying solely on BT’s analysis as it will have an incentive to only put forward cost changes that work in its favour and against the purchasing parties. It is no surprise, therefore, that each of the corrections and adjustments put forward by BT in its response would have the effect of reducing the size of the overcharge. This is in contrast to Ofcom’s proposed set of adjustments and corrections, some of which raise the level overcharging and others which reduce it (although the combined effect increases the overall level of overcharging);
- b) The effect of accepting some of BT’s adjustments would be to move certain costs into AISBO services from elsewhere or between different services within the AISBO market. However, previous regulatory decisions – such as cost orientation assessments and the setting of charge controls – have been predicated on the basis of the previous cost allocations. Were one minded to accept the adjustments put forward by BT then one would need to revisit these previous decisions in light of the adjusted data. In Sky’s view this is impractical;
- c) In some cases, the “errors” cited by BT occurred over six years ago but have only now come to light ([CONF]);
- d) Ofcom has already explained in its draft determination why it considers that BT’s so-called “DSAC errors” are not errors at all but are, instead, the outcome of a different methodological approach to the one that it previously adopted. Ofcom considers that

¹⁴ §ES13, BT, *op cit.*

both are “allowable”. Sky has not identified anything in BT’s response that proves that its previous DSAC calculations are in error in relation to this point;

- e) If the DSAC data is insufficiently robust and there is continued uncertainty as to the appropriate methodologies by which DSAC can be calculated, then in Sky’s view, this provides Ofcom with a further justification for relying on FAC data instead in order to resolve these disputes;
- f) BT puts forward alternative DSAC figures that are calculated by applying a proportionate adjustment to recalculated FAC numbers. We note, however, that Ofcom in its draft determination has proposed absolute adjustments to FAC in order to arrive at DSAC numbers. In the RGL report that accompanied Sky’s response, RGL expressed its view that the likely appropriate way of applying adjustments when calculating DSAC is dependent on the proportion of a service’s FAC that is made up of common costs and the nature of the adjustment itself. Generally, however, the adjustment could be expected to be somewhere between and proportionate and absolute adjustment. Either way, a consistent approach to adjustments would be required;
- g) In the context of payment terms, where BT suggests that an adjustment should be made to reduce the level of overcharging to reflect the actual length of time in which payments are made for Ethernet services by its customers as opposed to the contractually agreed payment terms that Ofcom applied in its overcharging calculations, Sky points out that BT is entitled to levy interest against late payments under its Ethernet contracts. To the extent that the relevant contractual interest rate reflects its economic loss, there is no need to make the adjustment proposed by BT; and
- h) It is entirely inappropriate for BT’s 21CN costs to be included in the calculation of BES and WES costs because these services do not use BT’s 21CN and as such should not contribute to those costs. To argue that 21CN supports the future successor Ethernet products to BES and WES is beside the point. Under Ofcom’s anchor product pricing approach, BT has been given pricing freedom for these successor products in order to recover these development costs. However, price regulation remains in place for BES and WES and does not allow for the recovery of 21CN costs.

SECTION 5 – NASCENCE

32. BT attempts to explain¹⁵ that, due to the nascent nature of the Ethernet market, it was difficult for it to accurately predict its costs and thus ensure that its prices were cost oriented. Sky has already dealt with the level of purported nascence and cost uncertainty in its own response to Ofcom’s draft determination.¹⁶ BT does not offer anything in its response that alters Sky view that the level of cost uncertainty was low because:
- a) While demand was growing for Ethernet services over the period in question, it was relatively predictable (especially for LLU backhaul);
 - b) There was little or no competition to BT in the provision of wholesale Ethernet services;
 - c) Openreach did not have a standing start as BT had been providing similar services for many years and many legacy LES circuits were migrated to BES soon after its launch;

¹⁵ Section 3.3, BT, *op cit.*

¹⁶ Section 6, Sky, *op cit.*

- d) Given that other newer services such as LLU were subject to price caps, merely applying a cost orientation remedy could be considered a relatively flexible approach;
 - e) Other services in declining markets (such as Partial Private Circuits) with similar cost uncertainty were subject to price caps;
 - f) Many sunk costs could be recovered from other products and services because they were common;
 - g) Ethernet technology was stable, established, simple and well-understood; and
 - h) BT should have had access to regular cost information on a monthly basis and, as such, it did not have to wait for the publication of the RFS before gauging whether its prices were cost oriented.
33. BT's response attempts to depict the last six years of the Ethernet market as highly volatile and confusing. This does not accord with Sky's experience as a purchaser of LLU backhaul (of which there are relatively few large scale operators). Sky's roll-out plans have been meticulously formulated and well-trailed. Sky is required to communicate these plans and its requirements to Openreach well in advance.

SECTION 6 – DURATION

34. There is nothing in the wording of Condition HH3.1 which allows BT's prices to deviate from its costs for a short period of time. The obligation is continuous but, in recognition that outturn costs may deviate from those forecast by BT it may be appropriate to allow minor breaches of the cost orientation ceiling.
35. Amongst other factors, however, the duration of any breach should be considered in the context of the predictability of costs, whether BT had generally erred on the side of caution in its pricing decisions (i.e. whether the breach was a "one-off" and pricing was generally below the ceiling) and the scale of the overcharge.
36. BT argues against the inclusion of some services in the overcharge calculation on the basis that prices only exceeded DSAC in one year. However, as noted above, BT would (or should) have been in possession of more regular monthly cost information and could have acted more quickly. Moreover, Sky does not consider that BT's costs were truly unpredictable or that the one-year breaches were "one-offs" (many other charges for other services were above DSAC). In fact, there is no evidence of BT erring on the side of caution in the face of the purported uncertainty and the level of the relevant overcharge was significant.
37. Sky notes that, as the Ethernet market was growing rapidly (but not unpredictably) during the period in question, even if connection prices were excessive for just one year, there could have been significant over-recovery and distortion.
38. In summary, Sky does not agree with BT's view that it is only appropriate to consider that charges were not cost oriented if they exceeded the cost orientation ceiling for more than one year.