

BT CHARGES FOR BACKHAUL EXTENSION CIRCUITS

**REQUEST TO OFCOM, PURSUANT TO SECTION 185 OF THE
COMMUNICATIONS ACT 2003, TO RESOLVE A DISPUTE
BETWEEN BSKYB, TALKTALK GROUP AND BT
27 JULY 2010**

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SUMMARY

1. This is a request to Ofcom (“**Dispute Referral**”), made pursuant to section 185 of the Communications Act 2003, for Ofcom to resolve a dispute relating to charges for backhaul extension services (“**BES**”) provided by British Telecommunications plc (“**BT**”) to third party communications providers between 24 June 2004 and 31 July 2009 (the “**Relevant Period**”). The parties to the dispute are BT and two purchasers of BES, namely British Sky Broadcasting Limited (“**Sky**”) and TalkTalk Telecom Group plc (“**TTG**”). The present request is made by Sky and TTG (together, “**the Purchaser Parties**”) because they have not been able to resolve the dispute by agreement with BT, despite genuine and persistent efforts to do so.

2. BES contribute to providing a high speed, permanently connected point-to-point secure data link between a communications provider’s core network and its equipment within the relevant unbundled BT local exchange. A list of BES products which the Purchaser Parties have purchased from BT, and to which the present dispute relates, is annexed to this Dispute Referral as Annex 1.

Background to BES and the SMP Conditions imposed on BT

3. Ofcom has made findings that BT has significant market power (“**SMP**”) in a number of different markets in which it supplies other communications providers, including the market(s) in which it provides BES products.¹ As a consequence of these findings, Ofcom has imposed SMP-related regulatory conditions on BT (“**SMP Conditions**”). These SMP Conditions fix BT with various obligations, including a ‘Basis of Charges’ obligation (Condition HH3), effective from 24 June 2004, which required BT to “secure, and [be] able

¹ Ofcom determined (in its Leased Line Market Review and then in its Business Connectivity Market Review) that BT has SMP in various markets for the provision of digital leased lines, including a market in which BT provides BES products to third parties. Ofcom’s 2004 Leased Line Market Review §10.7 and <http://stakeholders.ofcom.org.uk/binaries/consultations/bcmr08/bcmr08.pdf>, section 7.

*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*² (the “**Condition**”). (Emphasis added).

4. The Condition has at all times throughout the Relevant Period been applicable to the supply by BT of BES to the Purchaser Parties. The effect of the Condition, so far as is relevant for present purposes, is to: (a) require BT to secure that each and every of its charges for BES are derived in accordance with the Condition; and (b) fix BT with the burden of demonstrating that its charges have been, and are, compliant with the obligations contained within the Condition.
5. With effect from 1 August 2009, BT’s charges for BES have also been subject to specific price controls imposed by Ofcom. The dispute relates solely to the period immediately preceding the coming into force of the aforementioned price controls.

BT’s pricing is incompatible with its SMP Conditions

6. Throughout the Relevant Period, BT was required to set its charges for BES in accordance with the Condition (the “**Relevant Charges**”). In the submission of the Purchaser Parties, BT failed to do so. Its charges were significantly above what it was entitled to charge in accordance with the Condition. As a consequence, the Purchaser Parties have been overcharged for BES. The Purchaser Parties are thereby each entitled to receive a refund for the amount of the overcharge, together with interest (which the Purchaser Parties contend should be compound interest at an appropriate commercial rate). Only in this way can the Purchaser Parties be properly compensated for the overcharges they have suffered in consequence of BT’s breach of its regulatory obligations; and only in this way can BT be properly deprived of the benefit it has obtained by its breach.
7. The Purchaser Parties do not, of course, have the same degree of visibility as has Ofcom of BT’s costs and other financial information relevant to ensuring its compliance with the Condition. Nor do the Purchaser Parties have the powers available to Ofcom to require BT to

² Condition HH3 was differently-worded from its predecessor, Condition 69.1 of BT’s Licence of 2001. In particular, the words “allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed” were new, since they did not appear in Condition 69.1.

provide information. Notwithstanding these limitations, the Purchaser Parties have commissioned expert consultants RGL Forensics (“RGL”) to investigate the compatibility of the Relevant Charges with the Condition using, *inter alia*, BT’s regulatory financial statements. A copy of RGL’s report is annexed to this Dispute Reference at Annex 2.

8. The Purchaser Parties rely on the RGL report as support for their position that the charges have not been compliant with the Condition and that, as a consequence, the Purchaser Parties have been overcharged (persistently) during the Relevant Period. The RGL report sets out the results of accounting analysis undertaken by them, albeit necessarily on the basis of only such data concerning BT’s costs and revenues that is publicly available. The report’s conclusion is that BT’s revenues from its charges for certain BES products during the Relevant Period have been significantly in excess of BT’s costs of provision. Such conclusion is drawn whether one looks at *‘the costs of provision’* in terms of: (a) current cost accounting fully allocated cost (“CCA FAC”), or (b) distributed stand-alone cost (“DSAC”).

Determining ‘the costs of provision’

9. Ofcom has previously applied DSAC as a “*first-order test*”³ of compliance with the cost orientation obligation. It has also referred to the use of CCA FAC as a cross-checking mechanism; to ensure that the *‘costs of provision’* determined according to DSAC are appropriate.⁴ The difference between CCA FAC and DSAC is essentially the extent to which particular services bear common costs. DSAC distributes certain common costs to only a subset of the services that benefit from, and ought properly to make a contribution to, those costs. Therefore, if all products and services within an economic market were priced at DSAC, common costs would be significantly over-recovered. In contrast, if all products and services were priced at the level of CCA FAC, common costs would only be recovered once. As a result, less common cost is in effect allocated to a product under a CCA FAC methodology⁵ than under a DSAC methodology and therefore CCA FAC costs are less than DSAC costs.

³ http://stakeholders.ofcom.org.uk/binaries/consultations/draft_deter_ppc/PPC_final_determination.pdf

⁴ Ofcom’s 2009 Fixed Narrowband Service Wholesale Market Review and Ofcom’s 2004 Leased Line Market Review.

⁵ In a CCA FAC methodology the LRIC and common costs are not explicitly calculated but can be inferred. Under CCA FAC total incurred costs are allocated to the various products. The common cost allocation can then be inferred to equal the CCA FAC cost less the LRIC cost (the LRIC cost being derived using a different methodology).

10. The Condition, properly interpreted, requires BT to set charges by reference to its actual costs (looked at on a forward-looking long run incremental cost basis) and, in calculating those costs, to include an appropriate contribution towards meeting common costs.
11. The Purchaser Parties contend that, as set out in the RGL report, the Relevant Charges were (persistently) above DSAC and, as such, fail Ofcom's "first-order test". Further, even if all Relevant Charges had been at the level of DSAC, the application of a CCA FAC cross-check shows that the Relevant Charges were still considerably higher than the amount BT could properly charge in a competitive environment.
12. Accordingly, the Purchaser Parties contend that BT's Relevant Charges have been higher than permitted by the Condition; and the Purchaser Parties therefore request that Ofcom assesses the extent to which they have been overcharged.
13. Details of the amounts overcharged by BT are contained in the confidential annexes to this Dispute Referral (Annexes 3 and 4). In broad terms, the Purchaser Parties consider that communications providers (including the Purchaser Parties) have overspent on BES products due to BT's overcharging by £149 million (based on the application of CCA FAC).

There is an unresolved dispute which the Purchaser Parties are now referring to Ofcom

14. The Purchaser Parties have entered into discussions and negotiations with BT in an attempt to agree the amount of the overcharging and thus the amount that is repayable to them by BT. A chronology of these discussions and negotiations is annexed to this Dispute Referral as Annexes 5 and 6. Unfortunately, however, it has not been possible to resolve matters by agreement and the discussions and negotiations have now reached an impasse. Accordingly, the Purchaser Parties, by way of this Dispute Referral request that Ofcom resolves the dispute in accordance with its relevant Communications Act powers⁶ to:
 - determine the proper amount of the charges for BES services provided by BT to the Purchaser Parties from 24 June 2004 to 31 July 2009; and
 - for the purpose of giving effect to that determination, give a direction requiring BT:-

⁶ Sections 185 – 191 Communications Act 2003.

- to repay to the Purchaser Parties a sum equal to the difference between the amounts paid by them in respect of the Relevant Charges, and the amounts which would have been paid had those charges been no higher than if they had been set in accordance with the Condition, together with interest on that sum at such rate and for such period as may be appropriate and just; or alternatively,
 - to repay to the Purchaser Parties such other amounts as Ofcom may determine to be appropriate and just.
15. In the Purchaser Parties' submission, it is appropriate that BT be required to pay interest on the amounts by which it has overcharged them. Such requirement is appropriate and necessary for properly remedying BT's breach of the Condition, compensating the Purchaser Parties fully for the overcharge and ensuring that BT is required to fully disgorge the benefit it has obtained by that breach.
16. To the extent that BT has, by the standard contractual terms and conditions it has imposed on the Purchaser Parties, sought to deny them interest on amounts by which Ofcom determines them to have been overcharged, the Purchaser Parties submit as follows:
- Ofcom's discretion in relation to the directions to be given to resolve the dispute and properly remedy BT's breach exists independently of, and is not limited by, any contractual term imposed by BT on its customers, and Ofcom therefore retains the ability to, under section 190 of the Communications Act 2003, direct a remedy that is sufficient and fair. BT cannot, by the contractual terms it imposes on its customers, limit Ofcom's discretion or prevent Ofcom from directing a sufficient remedy.
 - Further or in the alternative, BT's contractual exclusion of interest has at all material times been contrary to SMP Condition HH1.2, which required BT to provide Network Access on "*fair and reasonable terms*". It is neither fair nor reasonable for BT to deprive its communications provider customers of full and proper remedies (as assessed by the regulator), where those customers have been overcharged as a consequence of BT's breach of its regulatory obligations. The exclusion is therefore invalid and BT cannot properly rely on it.

17. In the Purchaser Parties' submission, the appropriate measure of interest is compound interest at a commercial rate which Ofcom has the power to determine as part of resolving this dispute.

18. Should Ofcom require any information or clarity in relation to the dispute, it should contact either Bruce Breckenridge or Matthew Marsh at Sky and/or Rickard Granberg at TTG.

SECTION 1 - BES PRICES ARE REQUIRED TO BE SET BY REFERENCE TO COSTS

A) BES are ethernet-based LLU backhaul circuits

19. BES are ethernet-based, high speed, permanently connected point-to-point data circuits which provide a secure, dedicated fibre optic link between equipment located in a BT exchange owned by a local loop unbundling (“LLU”) operator and its core network.⁷ Schedule 2 of BT’s standard BES contract confirms that BES uses the ethernet networking technology standard:⁸

“1.1 Backhaul Extension Service (BES) Services are high speed point to point ethernet data circuits.”

20. BES services are of critical importance to LLU operators and are purchased predominately to facilitate the provision of broadband and voice services to an LLU operator’s customers.
21. Contained at Annex 1 is a detailed description of the various BES products and the prices for such products. Both parties purchase predominantly a mix of 100 Mb/s circuits and 1 Gb/s (known as BES 100 and BES 1000). Openreach⁹ publishes a price list for its ethernet portfolio¹⁰, charging separately for:
- connection, the price of which is dependent upon the amount of available bandwidth;

⁷ From its dedicated space facility (“co-location”) within the BT exchange, an LLU operator will aggregate all of its customers’ access circuits (circuits which connect a customer premises to the co-location facility) onto the BES circuit. The BES circuit will then be used to transport data between the customer access circuits and a ‘Point of Presence’ or node in the LLU operator’s core network. BT supplies the fibre optic circuit replete with Network Termination Equipment (“NTE”) at each end. The LLU operator will connect its equipment to the NTE. An LLU operator can use the BES product to connect the BT exchange to its core network or alternatively can group together a number of BT exchanges before connecting them to its core network via the ‘BES Daisy Chain’ product.

⁸ <http://www.openreach.co.uk/orgp/products/ethernet/bes/eoibes.do>

⁹ Openreach is the division within BT that is responsible for providing BES.

¹⁰ Included with Annex 1 but also available from: <http://www.openreach.co.uk/orgp/pricing/loadProductPriceDetails.do?data=kxWGSeZ9BRMKF3tctK4117%2FuVhXjMR5hQz3DdrCHJqBvRwsgMC%2F4dy9qJJFTkna2>

- rental of each “end” of the circuit typically between the customer’s core network node and the BT local serving exchange, the price of which is dependent upon the amount of available bandwidth;
- rental of the main span of circuit between each “end” (known as the “mainlink”), the price of which is based on the length of the link in metres irrespective of bandwidth; and
- other charges including upgrades, cancellations and resilience.

22. Annex 3 and Annex 4 set out details of the amounts that Sky and TTG have each paid in respect of BES services during the Relevant Period.

B) BES products fall within the Wholesale Alternative Interface Symmetric Broadband Origination market

23. Ofcom has determined that BES products (described below by Ofcom as “LLU backhaul services”) fall within the market for wholesale alternative interface symmetric broadband origination (“AISBO”) services. In June 2004, Ofcom published the findings of its Leased Lines Market Review (“LLMR”). In the LLMR, Ofcom stated that:

“1.38 LLU backhaul services are another type of symmetric broadband origination service.

1.39.....LLU backhaul services can be provided using traditional or alternative interfaces.

...

1.43Ofcom has identified a separate range of symmetric broadband origination services that have particular distinguishing characteristics. Ofcom is referring to these as alternative interface symmetric broadband origination (AISBO) services.

...

10.7 In the following markets where Ofcom concludes that BT should be designated as having SMP:

...

- *wholesale alternative interface symmetric broadband origination (AISBO)...”¹¹*

¹¹ Ofcom’s 2004 Leased Line Market Review

24. As a result of the aforementioned SMP, Ofcom imposed SMP conditions upon BT in respect of its wholesale AISBO products, including BES, which include:

- an obligation to provide network access on fair and reasonable terms;
- a Basis of Charges condition; and
- an accounting separation and transparency obligation.

i) Obligation to provide network access

25. The requirement to provide “Network Access” is referred to in Condition HH1¹². Condition HH1.1 states

“Where a Third Party reasonably requests in writing Network Access, the Dominant Provider shall provide that Network Access.”

26. BT is therefore required to provide “Network Access”¹³ to, amongst other things, BES products. It is common ground that BES constitute Network Access within the meaning of Condition HH1.

ii) Basis of Charges Condition

27. With regard to the setting of charges, Ofcom stated in the LLMR that the charges for products to which BT is required to provide Network Access – including BES – should be reasonably derived from the actual incurred costs of providing those services and that the costs must be

¹² “Condition HH1. Requirement to provide network access on reasonable request:

HH1.1 Where a Third Party reasonably requests in writing Network Access, the Dominant Provider shall provide that Network Access. The Dominant Provider shall also provide such Network Access as Ofcom may from time to time direct.

HH1.2 The provision of Network Access in accordance with paragraph HH1.1 shall occur as soon as reasonably practicable and shall be provided on fair and reasonable terms, conditions and charges and on such terms, conditions and charges as Ofcom may from time to time direct.

HH1.3 The Dominant Provider shall comply with any direction Ofcom may make from time to time under this Condition.”

¹³ The term “Network Access” is not specifically defined in the SMP Conditions set out in the 2004 LLMR Statement. The SMP Conditions, however, make clear that – except insofar as the context otherwise requires, words or expressions shall have the meaning assigned to them and otherwise any word or expression shall have the same meaning as it has in section 151 of the Communications Act 2003.

calculated on a forward looking incremental cost approach, allowing an appropriate mark-up for the recovery of common costs:

“7.56 Ofcom therefore considers that it is necessary to apply a cost orientation obligation. The condition sets out that the charges for services should be reasonably derived from the costs of providing those services. It further states that the costs must be calculated on a forward looking incremental cost approach, and allowing an appropriate mark-up for the recovery of common costs including an appropriate return on capital employed.

7.57 The condition will apply across all services within this market. This means that the price of all services provided by BT in the market should be based on LRIC and allowing an appropriate mark-up for the recovery of common costs.”

28. SMP Condition HH3, which can be found in the LLMR and also in the 2008 Business Connectivity Market Review (“**BCMR**”) which re-affirmed both the relevant finding of SMP and the continuation of the Condition¹⁴, ensures that charges for Network Access, including BES products, are reasonably derived from the costs of provision:

“Condition HH3. Basis of Charges

HH3.1 Unless Ofcom directs otherwise from time to time, the Dominant Provider 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

HH3.2 The Dominant Provider shall comply with any direction Ofcom may from time to time direct under this Condition.”

29. During the Relevant Period, BT’s charges for its BES products should therefore have been derived in compliance with Condition HH3. The burden of proof falls on BT to demonstrate

¹⁴ In the BCMR Ofcom split the wholesale AISBO market into two separate markets (namely “low bandwidth AISBO” and “high bandwidth AISBO”). The “low bandwidth AISBO” market contains BES products with speeds of up to and including 1 Gb/s. Ofcom found that BT had SMP in this market. It is this market (and the products in this market) that are relevant to this dispute.

to the satisfaction of Ofcom that each and every charge for BES has been compliant with Condition HH3.

30. Since 1 August 2009, BT's BES products, amongst other products in the low bandwidth AISBO market, have additionally been subject to a charge control framework (the "**Charge Controls**"). The detail of the framework is set out in Ofcom's statement on "Leased Lines Charge Control".¹⁵ The Charge Controls place a more explicitly defined constraint upon BT's pricing for its BES products, with the consequence that in addition to the cost orientation requirements, BT cannot, in respect of any relevant service, set a charge (or combination of charges) that is above the caps set by Ofcom through the Charge Controls.
31. The Charge Controls are not the subject of this present dispute (but the fact that they were imposed by Ofcom after the Relevant Period is, in the Purchaser Parties view, a clear indication of BT's persistent market power during this period).¹⁶ The present dispute relates solely to the charges made by BT for BES products during the Relevant Period.

iii) Accounting separation and transparency obligation

32. In order to demonstrate that charges for, amongst other things, BES products, have been reasonably derived from the costs of provision, BT is required to comply with an accounting separation obligation which applies to the AISBO market.¹⁷ In the LLMR Statement, Ofcom stated, in relation to the accounting separation and transparency obligation, that:

"given the importance of this issue [the need to ensure that BT did not unduly discriminate in favour of its own retail activities in such a way that may have a material effect on competition] in ensuring effective competition, Ofcom believes that it is necessary that BT should be obliged to have an accounting separation obligation. This obligation will enable Ofcom to monitor whether BT is unduly discriminating against or between other providers, by making visible the wholesale prices and

¹⁵ Section 5 of the Leased Lines Charge Control statement. <http://stakeholders.ofcom.org.uk/binaries/consultations/lcc/statement/lccstatement.pdf>

¹⁶ However, the Purchaser Parties reserve their position with respect to whether the charges applied by BT following the coming into force of those Charge Controls are fully compatible with all relevant SMP regulation to which BT is subject, including the Charge Controls themselves and the Basis of Charging obligation. The Purchaser Parties also reserve their position with respect to the pricing of other LLU Backhaul services such as Connectivity Services and all LLU Backhaul services prior to the Relevant Period.

¹⁷ Section 10 of the LLMR, in particular, see paragraphs 10.11-10.12 and 10.24-10.25.

internal transfer prices of its services and products. Therefore, the accounting separation obligation for BT will apply to the markets identified above. [including the AISBO market.]”¹⁸

33. The relevant SMP Condition imposed on BT in July 2004 is contained in a regulatory financial reporting obligations statement.¹⁹ That condition, by virtue of the LLMR, applies to BES products. The condition states as follows:

“OA32 BT shall maintain a separation for accounting purposes of the Accounting Separation Market Activities from other activities and of Accounting Separation Activities from other activities, so as to:

a. identify all elements of revenue, cost, assets and liabilities, with the basis of their calculation and the detailed attribution methods used, related to the Accounting Separation Market Activities and Accounting Separation Activities including an itemised breakdown of fixed assets; and

b. ensure that Accounting Separation Market Activities and Accounting Separation Activities are identified and are recorded at an appropriate amount in accordance with the Accounting Documents.”

34. Thus, BT has at all material times been required to account for its BES products in a transparent and separate manner and to make the wholesale prices for its BES products visible to third parties. It is submitted that this SMP obligation requires BT to organise its regulatory accounts in a way that reflects other SMP obligations, notably SMP condition HH3 which requires each and every charge to be cost-orientated.

¹⁸ §10.25 of Ofcom’s 2004 Leased Line Market Review.

¹⁹ Formerly available at http://www.ofcom.org.uk/consult/condocs/fin_reporting/fin_report_statement/finance_report.pdf

SECTION 2 – BT’S RELEVANT CHARGES IN THE RELEVANT PERIOD HAVE EXCEEDED THOSE PERMITTED BY SMP CONDITION HH3

2.1 BT has failed to comply with Condition HH3

35. The Purchaser Parties submit that BT has failed to comply with the Basis of Charges obligation set out in the Condition with regard to BES during the Relevant Period.
36. Throughout that period, the Basis of Charges obligation required BT to ensure that each and every charge offered for BES was reasonably derived from the costs of provision of that service, based on a forward looking LRIC approach that allows for an appropriate mark-up for the recovery of common costs including an appropriate return on capital employed.
37. This dispute turns on two questions, namely: (a) how the Condition should be interpreted with regard to the charges for BES products (in particular, which appropriate cost standard and test applies to each BES product); and (b) whether and to what extent BT’s charges for BES products during the Relevant Period have been above the charges permitted by the Condition. The Purchaser Parties set out below the standard they believe should apply in this case and why BT has failed to meet that standard.

2.2 The right approach generally

38. For the purpose of determining the correct approach for assessing compliance with the Condition, the starting point must be the requirements set out in that Condition. The Condition requires that “*each and every charge ... for Network Access*” be “*reasonably derived from the costs of provision*”. Accordingly, the right approach must be to first identify the particular charges in question, and to then identify “*the costs of provision*” of the particular service for which that charge has been made (with such costs to be assessed in accordance with the principles set out in the Condition). Once “*the costs of provision*” have been ascertained, it is then possible to consider whether the charge has been “*reasonably derived from*” those costs.

2.3 The appropriate level of service aggregation

39. Since the Condition requires that “*each and every charge... for Network Access*” (emphasis added) be “*reasonably derived from the costs of provision*”, the assessment of whether BT’s charges for BES products have complied with the Condition should be made on a charge-by-

charge basis. Accordingly, it is necessary to consider whether BT's charges for each individual service (connection, rental and mainlink) is itself reasonably derived from the costs of provision of that service.

40. The need to consider BT's charges in that way flows from the wording of the Condition, but there are also a number of other factors that support this approach:

- (i) customers of BES services do not purchase connection, rental and mainlink in fixed proportions (for instance: rental and connection will be used in different proportions depending on the length of time a circuit is rented for; and the length (and cost) of the main link will differ by customer and exchange). Therefore, unjustifiably high prices for either connections, rentals or mainlinks give rise to the potential for economic harm through distortions to retail consumption decisions, investment or competition between communications providers (even if prices in aggregate are not excessive). It cannot have been envisaged that BT could pursue recovery of a disproportionate share of its costs of providing *all* Network Access, or *all* BES, from a smaller subset of products, thus potentially advantaging itself (in relation to those products which it does not itself purchase in large quantities) and/or potentially distorting competition;
- (ii) BT must have understood the Condition to apply on a charge-by-charge basis because it reports connection, rental and mainlink costs separately in its regulatory financial statements; and
- (iii) some of the costs associated with the products are distinguishable from each other.

2.4 Assessing “the costs of provision”

41. The Purchaser Parties note that Ofcom has previously applied DSAC to determine whether BT has overcharged for certain of its products to which the cost orientation obligation applies. Most recently, it applied DSAC in its determination of the Partial Private Circuits (“PPCs”) dispute. In resolving that dispute, Ofcom stated that DSAC is a “*first order test*” in determining the basis of its calculation of the retrospective overpayment for PPCs:

“1.21 Our methodology can be summarised as follows:

As a first order test, we assessed whether the charges levied by BT for each PPC service under dispute exceeded the relevant cost ceiling, i.e. the DSAC, for that service.

...

[5.29] (i) *As a first order test, we assessed whether the charges levied by BT for each PPC service under dispute exceeded the DSAC for that service.*"²⁰

42. DSAC is calculated by allocating a share of common costs to add to the LRIC cost.
43. The Competition Commission's recent determination in the case of *Cable & Wireless v Office of Communications* refers to the application of DSAC by Ofcom. In the determination, the Competition Commission states:

"3.327. Ofcom explained that it would see prices being within the relevant DLRIC and DSAC as an important first order test to assess cost orientation.

...

*3.352....Given that Ofcom generally considered DSAC as a ceiling for cost orientation of charges and charges above DSAC as potentially anti-competitive, the decrease in price to DSAC would seem in line with Ofcom's objective."*²¹

44. DSAC is not, however, an infallible way to measure the amount BT has overcharged for BES (it is perhaps for this reason that it is only a 'first-order test'). The reasons for this are as follows:

- First if an SMP operator were able to price all the products in a relevant market at DSAC, then it would be likely to be able to materially over-recover its common costs. As a result, it would tend to achieve high returns on capital employed ("ROCE") across its portfolio of products in that market. Such a rate of return would be inconsistent with the Basis of Charges obligation, which allows for an "*appropriate mark up for common costs including an appropriate return on capital employed*". (Emphasis added).

²⁰ http://stakeholders.ofcom.org.uk/binaries/consultations/draft_deter_ppc/PPC_final_determination.pdf

²¹ http://www.competition-commission.org.uk/appeals/communications_act/final_determination_excised_version_for_publication.pdf

- Second, furthermore, setting all prices at DSAC cannot be regarded as an outcome consistent with a competitive market. The high levels of profitability that such an outcome would provide would attract competitors and lead to lower prices, eroding the over-recovery of common costs. Basic economic principles suggest that prices would be driven down to the point where efficient firms were recovering all of their costs, including an appropriate return on capital, but no more.

45. To mitigate the aforementioned risks and issues, the Purchaser Parties believe that Ofcom should use the CCA FAC cost benchmark to determine whether it would be appropriate in the particular circumstances of BES overcharging to require BT to price BES services to this cost standard. In the 2004 LLMR Ofcom commented:

“In relation to the basis of charges, Ofcom has previously indicated elsewhere that CCA FAC can in certain cases be a good proxy for LRIC plus mark-ups.”²²

46. Recently, Ofcom has used CCA FAC as the appropriate methodology to calculate BT’s cost base. In the 2009 Leased Line Charge Control Ofcom stated:

“To determine BT’s base year costs, we had to decide upon the appropriate cost basis to use....

We have decided that the use of CCA FAC is an appropriate cost basis for the LLCC (subject to relevant adjustments) and we note that most stakeholders providing views on this issue supported its use.”²³

47. Ofcom also used the CCA FAC methodology in its Fixed and Narrowband Service Wholesale Market Review (albeit that the Annex from which the following statement is drawn has now been withdrawn by Ofcom). In that review, Ofcom refers to the use of CCA FAC methodology as the “*appropriate cost benchmark*” when interpreting the ‘Basis of Charges obligation’:

²² Paragraph 10.12 of the 2004 LLMR.

²³ Ofcom Leased Line Charge Control Statement 20 July 2009 paragraph 3.175.

“In the event of a dispute in relation to the prices charged for these [regulated] products we would interpret the Basis of Charges condition consistently with the approach we would normally take to setting a charge control, i.e. we would expect the appropriate cost benchmark to be longrun incremental costs plus an equal proportionate contribution to common costs (“LRIC+”) during the period (or CCA fully allocated cost as a reasonable proxy).”²⁴

48. For the avoidance of doubt, the Purchaser Parties consider that should Ofcom use DSAC as a first order test, Ofcom should, nevertheless, conduct a cross-check using CCA FAC to determine whether BT has complied with its cost-orientation obligations. The Purchaser Parties believe that the CCA FAC cross-check will show that BT’s Relevant Charges were not cost orientated.

2.4 BT has maintained BES prices above both DSAC and CCA FAC during the Relevant Period

49. The Purchaser Parties submit that BT has, during (and indeed throughout) the Relevant Period, imposed charges for BES services that have generally exceeded both DSAC and CCA FAC. The details of this overcharging are set out in the report by RGL Forensics which can be found in Annex 2. The RGL report concludes that:

- (i) BT’s returns for the AISBO market as a whole were persistently in excess of those consistent with a competitive market;
- (ii) BT’s revenues for the AISBO market were significantly higher than the ceiling DSAC costs (and thus even more significantly above CCA FAC costs) for BES services in aggregate between 2006/7 and 2008/9; and
- (iii) BT’s revenues for (particularly) the BES 100Mbit/s and BES 1000Mbit/s rental services were significantly above DSAC costs.

50. The RGL report considers that BT’s reported costs for BES connection services are too unreliable to reach definitive conclusions around the precise extent of over-recovery above DSAC by BT during the Relevant Period. The Purchaser Parties submit that Ofcom should

²⁴ §14.5 of Annex 14 to the Fixed Narrowband Service Wholesale Market Review.

require BT to provide a breakdown of connection costs and revenues for BES services with a view to determining the amount of the overcharging by BT and its compliance (or otherwise) with its cost-orientation obligations for these services as is required by HH3.

2.5 BT has failed to comply with the ‘Basis of Charges’ obligation

51. The Purchaser Parties submit that BT has failed to comply with the ‘Basis of Charges’ obligation. The evidence provided by way of the RGL report makes it imperative for BT to be required to demonstrate, and to satisfy Ofcom, that each and every one of its charges have, throughout the Relevant Period, been “*reasonably derived from the costs of provision*” and thereby compliant with the obligation.

52. The Purchaser Parties will comment on any arguments that BT may put forward. In the absence of justification being established, Ofcom should conclude that BT is in breach of the obligation, which has at all material times required BT not only to ensure, but also to be able to demonstrate, that its charges were “*reasonably derived from the costs of provision*”.

SECTION 3 – BT SHOULD BE REQUIRED TO REFUND PURCHASERS OF BES PRODUCTS TO THE EXTENT THAT THOSE PURCHASERS HAVE BEEN OVERCHARGED

53. As set out above, the Purchaser Parties submit that BT has, by its Relevant Charges, breached its regulatory obligation under the Condition. If BT has indeed been responsible for such breach, it will thereby have boosted its revenues and working capital at the expense of the Purchaser Parties. As a matter of principle, therefore, BT should be required to pay back these revenues (with interest). It should not be allowed to retain the benefit of its own wrongdoing.
54. Further, BT's overcharging has had a significant impact on the Purchaser Parties (and therefore ultimately their customers). The amounts by which the Purchaser Parties consider themselves to have been overcharged are set out in Annexes 3 and 4.
55. Another impact of excessive BES charges has been to constrain the scale and pace of LLU roll out which, in turn, has affected when and where LLU-based services have been offered to consumers. For example, where LLU operators have not been able to justify the cost of unbundling an exchange (or have delayed a decision to do so):
- (a) consumers face higher fees for 'off-net' (i.e. not unbundled) products that offer low margins to such operators²⁵;
 - (b) LLU operators are not able to offer off-net consumers the same type of services that can be offered to on-net customers²⁶; and
 - (c) the LLU operator has a reduced ability to take advantage of scale economies.
56. In addition, excessive BES charges have resulted in distorted and weakened competition since the Purchaser Parties (and other operators) were disadvantaged compared to BT itself who did not face the same excessive costs that were charged to the Purchaser Parties.

²⁵ Both TTG and Sky have been able to offer free broadband as part of a bundle to on-net customers whereas off-net customers pay higher prices.

²⁶ Such as ADSL2+ or generous download caps.

SECTION 4 - THE PURCHASER PARTIES ARE IN DISPUTE WITH BT, NEGOTIATIONS HAVE NOW REACHED AN IMPASSE, AND OFCOM SHOULD THEREFORE PROCEED TO DETERMINE THE DISPUTE

4.1 Negotiations are deadlocked

57. The Purchaser Parties initially wrote to BT with concerns about the overcharging of BES products in January 2008 (the Purchaser Parties were able to substantiate their previous belief that BT was overcharging for BES only after reviewing BT's 2007 regulatory financial statements; these statements provided the level of granularity needed to confirm the fact of the overcharging).
58. There have been discussions and correspondence between the Purchaser Parties and BT, some of which were on a without prejudice basis, (details of the discussions and correspondence which Sky and TTG can disclose are set out in the confidential Annexes 5 and 6 respectively). Those discussions have not reached a successful outcome. It should also be noted that TTG acquired Tiscali UK in July 2009 and that this dispute therefore also encompasses BES services purchased by Tiscali.

4.2 Ofcom's dispute resolution powers

59. Section 185 of the Competition Act 2003 empowers Ofcom to handle certain types of disputes referred to it. As is evidenced in the body of this document and in the annexes, there is a "dispute" between the communications providers with respect to the amount of overcharging by BT in relation to BES products. The Purchaser Parties have each tried to resolve the dispute with BT. However, negotiations have now reached an impasse and there is no real prospect of an agreement being reached to resolve the matter. The Purchaser Parties have not identified any alternative means available for resolving the dispute that is likely to result in a negotiated settlement.
60. Sky and TTG also note the aforementioned PPC dispute is now the subject of an appeal to the Competition Appeal Tribunal.²⁷ Whilst there may be some common issues between the present dispute and the PPC dispute there also significant differences. Neither Sky nor TTG consider that such common issues preclude Ofcom from proceeding to open its investigations now and to resolve the present dispute.

²⁷ <http://www.catribunal.org.uk/237-5136/1146-3-3-09-British-Telecommunications-Plc-.html>

4.3 Request for Ofcom to resolve the dispute

61. In light of the above, and the information contained in the annexes, the Purchaser Parties request that Ofcom resolve the dispute using its powers under section 190 of the Communications Act 2003.

SECTION 5 - REMEDIES

62. The Purchaser Parties ask that Ofcom resolve the dispute under section 190 of the Communications Act 2003 by:
- determining the proper amount of the charges for BES services provided by BT to the Purchaser Parties from 24 June 2004 to 31 July 2009; and
 - for the purpose of giving effect to that determination, giving a direction requiring BT:-
 - to repay to the Purchaser Parties a sum equal to the difference between the amounts paid by them in respect of the Relevant Charges, and the amounts which would have been paid had those charges been no higher than if they had been set in accordance with the Condition, together with interest on that sum at such rate and for such period as may be appropriate and just; or alternatively,
 - to repay to the Purchaser Parties such other amounts as Ofcom may determine to be appropriate and just.

Interest

63. In the Purchaser Parties' submission, it is appropriate that BT be required to pay interest on the amounts by which it has overcharged them. Such requirement is appropriate and necessary for properly remedying BT's breach of the Condition, and ensuring that BT is required to fully disgorge the benefit it has obtained by that breach. In view of these purposes, the interest should be compound interest at a commercial rate.
64. The following clause of BT's BES agreement (which set out the terms on which BT was/is prepared to contract with other communications providers, including the Purchaser Parties), appears to have the effect of imposing a contractual bar on BT having to pay interest on an order/direction by Ofcom requiring BT to repay an overpayment by a communications provider:

"12.3 If a refund is due to the Communications Provider by BT (unless that overpayment results from information provided by the Communications Provider

which is not attributable to information provided by BT), the Communications Provider may charge daily interest on late repayments at the Interest Rate for the period beginning on the date on which the parties agree BT shall make the repayment and ending on the date BT actually makes payment. If any charge is recalculated or adjusted with retrospective effect under an order, direction, determination or requirement of Ofcom, or any other regulatory authority or body of competent jurisdiction, the Purchaser Parties agree that interest will not be payable on any amount due to either party as a result of that recalculation or adjustment.”

65. Where interest is payable under the BES Agreement, it is payable at the “Interest Rate”, which is defined as follows:

“Interest Rate” means four percent above the base lending rate from time to time in force of HSBC PLC or such other bank which is a member of CHAPS Limited as BT may from time to time nominate in writing;

66. The BES Agreement is a standard contract to which all communications providers are required to sign up to should they wish to procure BES products. There is no option for bilateral variations in the contract. Although there are periodic contract reviews, these are limited in scope, and the Purchaser Parties have at all material times been unable to negotiate variations by themselves. In effect, therefore, the Purchaser Parties had no choice but to accept the standard terms of the BES Agreement in order to be able to obtain Network Access from BT in the form of BES products.
67. In the Purchaser Parties’ submission, BT is not properly entitled to rely on the interest exclusion term which it included in the BES Agreement, to defeat an entitlement to interest which the Purchaser Parties would otherwise have. That is for two reasons.
68. First, Ofcom’s powers to resolve a dispute are set out in primary legislation: section 190 of the Communications Act 2003. These powers include a power to give a direction requiring a communications provider to pay a sum of money to another communications provider. It is implicit in the scheme of the legislation and the regulatory regime that Ofcom is both entitled and required to make a judgment in each case as to what (if any) sum should be paid by one communications provider to another in circumstances where the first provider has breached the regulatory obligations applicable to it, and as a consequence has overcharged the other provider. Ofcom can and should make a judgment as to what sum is appropriate in order properly to remedy the breach. Ofcom’s power to set the sum which is to be paid, and thus to

ensure the proper and full remediation of a breach, cannot properly be limited by a contractual exclusion which has effectively been imposed by one communications provider on its customers.

69. Secondly and in the alternative, the contractual exclusion is invalid and/or cannot properly be relied upon by BT, because it is in breach of SMP Condition HH1.2, which requires BT to provide Network Access on “*fair and reasonable terms*”:

HH1.2 The provision of Network Access in accordance with paragraph HH1.1 shall occur as soon as reasonably practicable and shall be provided on fair and reasonable terms and conditions (excluding charges) and on such terms and conditions (excluding charges) as Ofcom may from time to time direct. (Emphasis added).

70. It is neither fair nor reasonable for BT to deprive its communications provider customers of full and proper remedies (as assessed by the regulator), where those customers have been overcharged as a consequence of BT’s breach of its regulatory obligations.

SECTION 6 – CONCLUSION

71. The Purchaser Parties have entered into discussions and negotiations with BT in an attempt to agree the amount of the overcharging by BT for its BES products and services in order to determine the amount that is repayable to them by BT.
72. Unfortunately, it has not been possible to resolve matters by agreement and the discussions and negotiations have now reached an impasse. Accordingly, the Purchaser Parties, by way of this Dispute Referral, request that Ofcom resolves the dispute in accordance with its relevant Communications Act powers²⁸ to:
- determine the proper amount of the charges for BES services provided by BT to the Purchaser Parties from 24 June 2004 to 31 July 2009; and
 - for the purpose of giving effect to that determination, give a direction requiring BT:-
 - to repay to the Purchaser Parties a sum equal to the difference between the amounts paid by them in respect of the Relevant Charges, and the amounts which would have been paid had those charges been no higher than if they had been set in accordance with the Condition, together with interest on that sum at such rate and for such period as may be appropriate and just; or alternatively,
 - to repay to the Purchaser Parties such other amounts as Ofcom may determine to be appropriate and just.

²⁸ Sections 185 – 191 Communications Act 2003.

ANNEX 1 – BES PRODUCTS BOUGHT BY THE PURCHASER PARTIES

BES Products purchased by Sky

- BES 100
- BES 100 Daisy Chain
- BES 1000
- BES 1000 Daisy Chain
- BES 1000 Extended Reach
- BES 10000

BES Products purchased by TTG

- BES 100
- BES 1000

ANNEX 2 – RGL REPORT

ANNEX 3 – AMOUNT OF OVERCHARGING FOR BES: CONFIDENTIAL TO SKY

ANNEX 4 – AMOUNT OF OVERCHARGING FOR BES: CONFIDENTIAL TO TTG

ANNEX 5 – CORRESPONDENCE WITH BT – CONFIDENTIAL TO SKY

ANNEX 6 – CORRESPONDENCE WITH BT – CONFIDENTIAL TO TTG