



**OFCOM**

**Business Connectivity Market Review and Leased Lines Charge Control**

**TalkTalk Group submission**

***Non-confidential version***

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# 1 Introduction

- 1.1 This is TalkTalk Group's (TTG) response Ofcom's consultations on the Business Connectivity Market Review ('BCMR') and Leased Line Charge Control ('LLCC').
- 1.2 TalkTalk Group provides broadband to over 4 million residential and business customers under the TalkTalk, AOL, TalkTalk Business and Pipex brands. We are the UK's biggest local loop unbundler, operate the UK's largest next generation network (NGN) and are Openreach's largest wholesale customer. As a result of these activities TalkTalk is a major purchaser of backhaul as well as, to a lesser degree access services totalling over £40m per year. TalkTalk only purchases AI/MISBO services.

## 1.1 Summary

- 1.3 The main points in our submission are outlined below.

### 1.1.1 Charge control, sub-cap and cost orientation

- 1.4 On Ethernet services Ofcom has proposed a single and broad basket with an RPI-12% charge control, a general sub-cap on each product at RPI-RPI and, in a significant departure from Ofcom's previous approach, no cost orientation obligation. This allows BT substantial flexibility on the pricing of individual products.
- 1.5 BT could use this flexibility benevolently to enhance welfare through Ramsey type pricing or pricing to encourage migration away from expensive legacy technologies. Alternatively, BT might use the flexibility to profit maximise through two exploitative / exclusionary pricing approaches that will harm welfare – setting relatively higher prices for products bought proportionately more by external customers (which allows BT to set prices above cost for external customers and so earn excessive revenue) and setting relatively higher prices in less competitive markets (which allows BT to weaken and distort competition).
- 1.6 The question is which of these pricing strategies will BT pursue in practice – the one that enhances welfare or the one that harms it. Ultimately, BT's rational behaviour when it sets prices is to maximise its profits – that is its fiduciary duty. It will pursue the strategy that will maximise profit which. In this case the profit maximising strategy that BT is likely to pursue will harm welfare:
  - 1.6.1 The profit from Ramsey pricing is likely to be low since the difference in elasticities is small, Openreach do not know the elasticities and much of the cost is not common within the basket.
  - 1.6.2 There is a large potential profit from setting higher prices for external competitors / less competitive markets since the basket is very broad and

highly heterogeneous (i.e. wide variations in internal versus external use, wide variations in competitive intensity).

- 1.7 Ofcom appear to have a rose-tinted view that BT will use the wide flexibility in welfare enhancing ways – Ofcom explain for example how BT has the “*incentive to set prices efficiently*” [LLCC §6.22]. That is plainly incorrect – BT underlying motives are not to enhance welfare or efficiency, they are to maximise its profits. BT’s pricing will only enhance welfare if the prices that profit maximising happen to also be welfare enhancing (which is far from certain). Further, Ofcom say that its general sub-cap will “*prevent harm to competition*” [LLCC §4.19]. This also is plainly wrong – a sub-cap does not prevent excessive prices it merely prevents the rate at which prices can diverge from cost and harm welfare. Further in this case, the large difference between the charge control X and sub-cap means that prices and costs can diverge quickly. If Ofcom continue with the large single Ethernet basket then a cost orientation obligation is essential as well as (under Ofcom’s current cost orientation interpretation) a tighter general sub-cap on individual products of RPI-6%. Cost orientation can also improve allocative efficiency by ensuring that prices are better aligned to actual costs without (in this case) weakening cost minimisation incentives.
- 1.8 We also consider that the removal of cost transparency obligations on BT which would make it impossible for CPs to understand how the prices they pay are related to cost is wholly unacceptable and unjustified (one sentence of reasoning is provided).
- 1.9 In light of the proposed abandonment of the cost orientation obligation we are disappointed that though there is a (much delayed) policy project properly assessing where the cost orientation obligation should apply and how it should be interpreted, in this LLCC Ofcom has opted to ignore the analysis and submissions that have been made and (on the basis of very scant and highly flawed reasoning) reverse Ofcom’s long held approach. This will essentially render (in respect of this market) any conclusions and approaches developed in the policy project as futile.

### 1.1.2 Passive remedies - PIA and dark fibre

- 1.10 Passive or ‘deep’ remedies have been extremely effective over the last 8 years in delivering more effective competition through exposing more of the value chain to competitive pressures and innovation. LLU has been the most obvious example of the substantial benefits passive remedies can bring.
- 1.11 Ofcom recognises that dark fibre and PIA can deliver benefits in the wholesale leased line markets. However, Ofcom have proposed not to mandate these remedies since they see ‘significant risks’. We think Ofcom’s assessment of the downsides is highly flawed:
- 1.11.1 Ofcom argue that allowing rival CPs the option of using passive remedies (rather than wholesale products) may result in inefficiency and may not provide advantages over wholesale products. Market forces will naturally

discipline against such outcomes – rival CPs will only invest using passive remedies if there are sustainable cost savings and/or advantages over BT's wholesale products. Ofcom seems to think that the market will make irrational commercial decisions.

1.11.2 Ofcom seems concerned that competitors will only focus on lower cost customers/geographies resulting in lower prices for them but higher prices for other customers. This may happen but if it does, we fail to understand what the problem with this is – such outcomes are normal in telecoms (and other) markets and are welfare enhancing since (in addition to the benefits of competitive entry) it means that prices are better aligned to cost which improves allocative efficiency.

1.11.3 Ofcom says it has not been presented with robust evidence to demonstrate material demand. This is not surprising since PIA and dark fibre is likely to be used initially on a case by case basis reacting to particular needs. However, in this case we do not understand why such evidence is required. Particularly in the case of PIA where the product is already available (but restricted in use) there would be no cost to allowing it to be used for providing wholesale leased lines. We see no downside in allowing PIA to be an option and seeing how it is used.

1.12 Ironically, if Ofcom had applied the logic it is now applying to PIA/dark fibre to LLU then LLU would never have got off the ground (or Ofcom may have restricted its use to certain exchanges) – almost every criticism of PIA/dark fibre is similarly true of LLU.

### 1.1.3 Other points

1.13 We agree with the use of the MEA. The related migration credit is highly generous to BT since Ofcom is effectively underwriting the risk of stranded assets whilst also allowing BT a high cost of capital which reflects (to some degree) the potential for stranded assets. Additionally, it also appears that Ofcom's approach to computing and applying the migration credit allows BT to recover three times as much revenue than is intended.

1.14 The £101m reallocation from TI to Ethernet is, in our view, excessive. The 'simple' approach that Ofcom has used to compute the amount results (for a number of reasons) in an inappropriately and unreasonably high reallocation. Further, there are sound economic reasons for reducing the reallocation for example: to encourage more efficient migration; send more efficient investment signals; and exploit Ramsey pricing efficiencies.

1.15 We consider that the operational efficiency assumption should be at the very top end of Ofcom's range (of 2% to 5%). Openreach has historically achieved efficiency gains at the mid/top end of this range. Further Openreach itself is projecting efficiency improvements above Ofcom's. There is absolutely no cogent reason for Ofcom to assume an efficiency improvement less than Openreach is assuming in

order to provide cost minimisation incentives – the cost minimisation incentive will be the same whether Ofcom’s efficiency assumption is 3%, 5% or 8%.

- 1.16 Ofcom has assumed zero capex efficiency since, it says, efficiency improvements are captured by Ofcom’s use of the MEA. This is incorrect. The application of the MEA provides the cost of modern technology in 2010/11. There will be efficiency and productivity gains in this technology between 2010/11 and the end of the charge control (2015/16). Further, there are capex items (e.g. duct, labour) which are not subject to the MEA assumption.
- 1.17 The previous approach to ECCs (which has been used to set current prices) has allowed BT to double recover its cost. This double recovery should be removed in calculating the 2015/16 cost stack (and Ofcom proposes to do so). In addition, Ofcom should make a starting price reduction to ensure that future prices during the charge control are not inflated by the past error. Ofcom should also consider whether the previous overcharge (and BT’s unjust enrichment) should be repaid.
- 1.18 We consider that applying the ‘rest of BT’ cost of capital to Ethernet services is excessive since Ethernet services have a materially lower risk profile than other products in the rest of BT. A suitable alternative is to use the BT Group cost of capital.
- 1.19 This charge control will not be implemented until April 2013 meaning that there will be a (about) six month interregnum period without a charge control applying. Openreach/BT has proposed interim prices for this period – these prices appear to be about the same (on average) as the previous period. This means that BT will earn external revenues about £13m more than they would have under Ofcom’s proposed charge control. We do not understand why Ofcom is letting BT get away with charging excessive prices particularly after it allowed BT to do the same on MPF rental prices in 2011/12 which resulted in around £15m of overcharge.
- 1.20 We consider that the the application of the charge control to single service-Ethernet products in the MISBO market (outside WECLA) is not wholly clear and needs clarification.

## 2 Business Connectivity Market Review

2.1 In this section we discuss many of the issues regarding Ofcom's proposals on the BCMR excluding the question of the structure of price related regulation (i.e. charge control, cost orientation etc). In particular, this section covers

- 2.1.1 Overview of Ofcom's proposals
- 2.1.2 Product market definition
- 2.1.3 Geographic market definition
- 2.1.4 Market power assessment
- 2.1.5 General SMP remedies
- 2.1.6 Other market review concerns (products within charge control, TRCs, and SLGs)

### 2.1 Overview of Ofcom's proposals

2.2 In broad terms, Ofcom's proposals for AI/MI business connectivity services<sup>1</sup> are the following:

#### 2.3 Product market (excluding TISBO)

- 2.3.1 Two separate markets: the AISBO market and the MISBO market.
- 2.3.2 The AISBO market is defined as all alternative interface services with a bandwidth of up to and including 1 Gbit/s.
- 2.3.3 The MISBO market is defined as multiple interface services with a bandwidth of over 1 Gbit/s and any services with WDM equipment at end-users' premises.

#### 2.4 Geographic market

- 2.4.1 Geographically, the markets are essentially defined as the WECLA area and the rest of the UK (excluding Hull) for both AISBO and MISBO

#### 2.5 SMP designation

- 2.5.1 Ofcom proposes that BT has SMP in the AISBO market in WECLA and rest of UK and in the MISBO market in the rest of the UK only.

#### 2.6 SMP remedies

- 2.6.1 With regard to the AISBO market, Ofcom proposes the 'standard' SMP remedies including a charge control

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<sup>1</sup> TalkTalk does not have any commercial interest in TISBO services so will not comment on Ofcom's proposals in relation to those. We will focus our comments on AISBO and MISBO services.

- 2.6.2 With regard to the MISBO market, Ofcom proposes a reduced number of SMP remedies and a very light charge control only on ‘single-service Ethernet products’
- 2.6.3 For both AISBO and MISBO there is no cost-orientation ‘basis of charges’ obligation. This is a significant deviation from Ofcom’s previous approach in BCMR and other markets e.g. LLU, WLR, NCC

## 2.2 Product market definition

- 2.7 We agree with Ofcom’s proposal to retain separate wholesale markets for alternative interface and traditional interface services respectively (at least for services below 1Gbit/s). The technical capabilities of AI and TI services tend to mean that they are not fully effective demand-side substitutes for one another. For example, TalkTalk has certainly never considered deploying TI services for the purposes of providing backhaul in its LLU network (which it started to build in 2005/6).
- 2.8 We can see the logic in identifying a combined market for terminating segments with any interface and delivering any service faster than 1Gbit/s, and for terminating segments delivered with WDM equipment at the customer’s premises (providing services at any bandwidth). We do believe there is growing evidence of demand-side substitution between AISBO circuits of higher bandwidth and WDM services (OSA services in Openreach terminology). Technically, we believe the services are substitutable in providing LLU backhaul solutions and the extent to which switching from higher bandwidth AISBO to WDM will largely depend on the pricing structure adopted by Openreach for its OSA services. Given this likely market development over the next 3-4 years, we have concerns over Ofcom’s proposals to restrict the charge control to “single service” Ethernet products and the legal ambiguity and regulatory uncertainty this is likely to bring. We comment further on this issue below at section 2.6.1.
- 2.9 We note Ofcom’s analysis of whether there is a combined market for access and backhaul and that Ofcom concludes that that it would be “premature” to define separate markets. The analysis is based on the fact that the “competitive conditions” in access and backhaul are “sufficiently similar” whilst Ofcom accepts that demand and supply substitution does not support such a conclusion.<sup>2</sup> In our experience, BT’s market share in backhaul remains significant and there are very few alternative suppliers. We would also project BT’s market share to remain stable or increase in this market over the next 3-4 years.
- 2.10 We note that Ofcom considers that asymmetric broadband is not in the same market as leased lines<sup>3</sup> and that this is due in part to the fact that asymmetric broadband does not have business grade features such as contention, latency/jitter, resilience, security and service level agreements/ guarantees (SLA/SLG). We note that the lack

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<sup>2</sup> BCMR consultation document, paragraph 4.187.

<sup>3</sup> BCMR consultation document, paragraph 3.170.

of these features is not for the most part inherent in asymmetric broadband technology (e.g. ADSL2+ or VDSL) but rather as a result of how BT has chosen to implement the technology – for instance, business grade SLA/SLGs could easily be offered on asymmetric broadband but BT have chosen not to for commercial (rather than any technical) reasons. We consider that this is due to BT wishing to avoid asymmetric broadband (both current generation i.e. ADSL2+ and NGA) because it would threaten to cannibalise its revenues from leased line services.

## 2.3 Geographic market definitions

- 2.11 We consider that Ofcom’s approach to defining geographic markets is a pragmatic and reasonable approach in this case.

## 2.4 Market power assessment

- 2.12 TalkTalk supports Ofcom’s assessment of market power in the AISBO and MISBO markets.
- 2.13 With regard to the AISBO market, BT retains a commanding market share both outside and inside the WECLA area. The entry barriers also remain very high such that the prospect for any competitive constraint developing over the market review period must be considered very remote. That BT’s market share has been almost static – 67% in 2011 versus 69% in 2007 [BCMR table 64] – reinforces the case that a significant reduction in future market share is unlikely.
- 2.14 With regard to the MISBO market, we agree with Ofcom’s assessment that this market will continue to grow during the period covered by this market review. Outside WECLA, we believe BT will be able to sustain a significant market share (above 50%) in this concentrated market and will be able to behave without competitive constraints. In relation to the WECLA, we note that Ofcom calculates BT’s market share to be around 15% in this geographic area. We have no evidence to challenge this figure << **CONFIDENTIAL** >>.

## 2.5 General SMP remedies

- 2.15 In relation to the AISBO market, we generally support the suite of SMP remedies that Ofcom proposes to impose on BT (for example: requirement to provide network access on reasonable request; requirement to provide all network access on Equivalence of Input basis; obligation not to discriminate unduly; publication of reference offer). There are significant entry barriers to this market due to the requirement to the high sunk costs involved for an alternative network operator who wishes to enter the market. We also note that BT’s market share has remained relatively stable since the last market review. It is clear that competition law alone would not address the competition concerns in this market and that ex-ante regulation remains necessary.

- 2.16 In relation to the MISBO market, Ofcom states<sup>4</sup> it includes two technically different services:
- 2.16.1 A CP installs WDM equipment at the customer's premises, allowing multiple services to be delivered using one pair of fibres; or
  - 2.16.2 A CP installs equipment that only allows a single service above 1Gbps, usually based on Ethernet, to be delivered using one pair of fibres ("single service Ethernet").
- 2.17 Ofcom continues by outlining four different "models of competition" (A, B, C and D model) and the relative strength of competition and prospective competition in relation to each of those scenarios.
- 2.18 TalkTalk has already migrated a large proportion of its BES portfolio to EBD << **CONFIDENTIAL** >>. It is not immediately clear to us which "model of competition" the purchase of backhaul would fall under although the closest analogy appears to be model C.<sup>5</sup> However, we are concerned that Ofcom's analysis does not cover the fast-moving pace of this market and that the relevance of a "single service Ethernet" MISBO product is becoming outdated (or will do so over the course of the period considered by this market review). Assuming backhaul falls within model C (or a reasonable extension of this model or indeed model D), we believe that the variant of OSA from Openreach to replace EBD is already commercially available. Although there may still be a technical distinction between WDM services and single service Ethernet, we would suggest that the distinction is becoming commercially irrelevant on the basis that there is evidence of demand-substitution between the two. We therefore believe that Ofcom must ensure that the charge controls proposed for Ethernet services takes into account Openreach's efforts to migrate Ethernet circuits to OSA technology to ensure no competition or consumer detriment arises.
- 2.19 Notwithstanding the above, we agree with Ofcom that the "*prospects for effective competition in the MISBO market outside the WECLA are likely to be poor, and that there would be a greater risk that end-users and consumers could be exposed to excessive pricing.*"<sup>6</sup> We accept the importance of maintaining CPs' incentives to invest on the basis of Models A and B as set out by Ofcom but we would caution that such investment is unlikely to mean more competition for LLU backhaul service segment of this market. << **CONFIDENTIAL** >>. It is essential therefore that the SMP remedies imposed on BT in the MISBO market are designed to protect CPs reliant on BT in this market segment.
- 2.20 In relation to the proposed SMP remedies, we have two specific concerns relating to the effectiveness of the proposed pricing constraints on Openreach (including the lack of a cost orientation obligation) and the design of the charge control obligation in relation to MISBO products. We outline those concerns in more detail at sections 3.1-3.6 below.

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<sup>4</sup> BCMR, §12.26.

<sup>5</sup> BCMR, page 559.

<sup>6</sup> BCMR, §12.56.

## 2.6 Other Market Review concerns

2.21 We discuss here three other related concerns from the BCMR – treatment of EBD, TRCs, and SLGs.

### 2.6.1 The treatment of EDB services within the MISBO market

2.22 Ofcom refers to the MISBO product market as “multiple interface services with bandwidth greater than 1Gbit/s, and services of any bandwidth delivered with WDM equipment at end-users’ premises.”<sup>7</sup> In relation to the EDB service available from Openreach, Ofcom refers to this being “WDM-based”.<sup>8</sup> TTG agrees that the EDB service uses WDM technology.

2.23 In relation to the proposed remedies for the MISBO market, Ofcom proposes to introduce a charge control on “single-service Ethernet products.”<sup>9</sup> More specifically, Ofcom says it is proposing “a charge control limited in scope to single-service Ethernet products only, and excluding services delivered with WDM equipment at customers’ premises.”<sup>10</sup>

2.24 The Annex to the proposed charge control SMP condition (Condition 5.3) lists all EBD services and thus brings them under the scope of the charge control (at the proposed level of RPI-12%). This seems appropriate. However, there is a possible inconsistency between Ofcom’s conclusion that WDM services will not be subject to the charge control and the SMP Condition 5.3 which in fact lists EBD services that are based on WDM technology. For the avoidance of any doubt (now or in the future), we believe that all EBD services should be covered by the charge control even if they use WDM technology.

### 2.6.2 Time related charges

2.25 We note that there is no constraint on BT’s pricing of time related charges (TRC)<sup>11</sup> – they are not included in a charge control basket and neither do they have a cost orientation obligation applied. Alternative providers such as TalkTalk have little choice but you purchase TRC services from Openreach. We do not understand why Ofcom believes that TRCs should not be subject to any price restrictions within this market (although they may be subject to cost orientation obligations in other markets such as the WLR/LLU markets). Failure to impose regulatory controls offers an opportunity to BT to engage in excessive pricing for a product that other providers have no option but to purchase from Openreach (because, for instance, other providers are not allowed by Openreach to use external contractors to carry out work on Openreach’s network).

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<sup>7</sup> See, e.g., BCMR consultation document, §1.14.

<sup>8</sup> BCMR consultation document, §11.38.

<sup>9</sup> See, e.g., BCMR consultation document, §1.52.

<sup>10</sup> BCMR consultation document, §12.75.

<sup>11</sup> LLCC consultation document, paragraph 6.62.

### 2.6.3 Service level guarantees

- 2.26 BT/Openreach has a history of delivering unacceptably poor levels of quality – for instance:<sup>12</sup>
- 2.26.1 Backhaul delivery (2005/2006);
  - 2.26.2 LLU migrations and fault repair (2007/2008);
  - 2.26.3 Co-mingling space / TAM / EBD (2009/2010); and
  - 2.26.4 LLU/WLR provisioning/repair (2010 and still ongoing).
- 2.27 In this last case for example it has been taking up to 40 days (or more) to get a new line provisioned. In fact, over the last three years Openreach has rarely (and for some products never) reached its own unstretching performance targets.
- 2.28 The underlying cause for low quality is that Openreach have little financial incentive to improve service. The level of SLGs are too small and/or avoidable and/or do not cover certain parts of the process which means that it is more profitable for Openreach (particularly in times of higher workload) to deliver low quality and pay out some SLGs than delivering a good (and acceptable) level of quality.
- 2.29 In order for SLGs to result in the delivery of reasonable quality, SLGs should be set to incentivise Openreach and also recompense harm to CP – i.e. a price that clears the market at optimal quality level. Only by doing this will the SMP conditions meet Ofcom’s objectives as it articulates it:
- “The conditions are aimed at promoting competition and securing efficient and sustainable competition for the maximum benefits for consumers by the implementation of an SLG regime that will incentivise BT to provide good quality of service to CPs.”<sup>13</sup>*
- 2.30 Ofcom proposes regulation that requires BT to offer SLGs, restricts ‘get out clauses’ and sets the quantum payable e.g. one month rental per day over CDD.<sup>14</sup> We generally consider these proposals are acceptable though not ideal. It should be noted that TalkTalk continues to experience problems the planning stage of delivering new circuits. There are no SLGs payable in the case of planning delays since the CDD is not set until after the conclusion of planning process. Ofcom should consider how it might bring create incentives for better performance in the planning process.

### 2.6.4 Openreach’s product development process

- 2.31 We continue to have concerns about the product development process in two respects:

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<sup>12</sup> The years refer to past periods where Openreach has delivered poor quality of service.

<sup>13</sup> BCMR consultation document, paragraph 11.159.

<sup>14</sup> LLCC consultation document, paragraph 11.157.

- 2.31.1 First, Openreach continues to act as an unresponsive monopolist – for example, in deciding whether to pursue developments it only considers whether there is a benefit for itself and it does not take account of benefits to CPs (the development of rings/chains for OSA are one example). Such monopolistic behaviour would not occur in a competitive market. It is a result of BT's market power and SMP remedies should (but do not) prevent such behaviour.
- 2.31.2 Second, we are concerned that Openreach continues to favour and fast track requests from internal business units (e.g. BT Wholesale) when it decides whether to develop new products. For instance, the introduction of the EAD Sync-E variant was requested (solely) by BT Wholesale and this product was prioritised over other urgent products even though there was no support from other CPs and no volume projections (and so benefit to Openreach estimates) were included.

### 3 Pricing remedies

- 3.1 There are two main *ex ante* remedies that Ofcom could use to constrain the pricing behaviour of Openreach – charge controls (possibly with sub-caps) and/or a cost-orientation obligation. In the case of Ethernet services, Ofcom has proposed to:
- 3.1.1 Impose a charge control on a very broad basket (with some limited sub-caps); and
  - 3.1.2 And, for the first time for major BT wholesale products, abandon the concurrent application of a cost-orientation obligation.
- 3.2 The proposed approach is wholly inadequate since it will allow BT to engage in harmful and/or anti-competitive pricing without actually breaching any SMP condition. Thus, we consider that Ofcom’s approach is wrong and will lead to consumer harm.
- 3.3 In this section, we outline what we believe to be the most appropriate way of ensuring that Openreach’s prices for AISBO services are constrained so as not to harm competition and consumers whilst allowing Openreach plenty of pricing flexibility. We also set out why we believe Ofcom’s proposed approach is inadequate and therefore fails to meet Ofcom’s statutory duty of protection consumers where appropriate by promoting competition.
- 3.4 We also outline our proposed regulation, the relationship to the cost orientation / RFS policy project and the proposed removal of the accounting transparency and ‘fair and reasonable’ prices obligations.

#### 3.1 Advantages and disadvantages of charge control baskets

- 3.5 We agree in principle with Ofcom’s approach of regulating prices by means of a charge control basket(s) rather than, for instance, charge controls on individual products. This approach allows BT the flexibility to adjust prices of individual products within the basket (whilst meeting the overall basket control). This approach has a number of potential economic and other benefits:
- 3.5.1 It allows prices to be optimised to demand increasing allocative efficiency (i.e. Ramsey pricing whereby more common costs are recovered from lower elasticity products) [6.18 b1].<sup>15</sup>
  - 3.5.2 It allows BT flexibility to manage efficient migration to lower cost technologies through reducing prices of the newer technology and raising prices of the legacy technology [6.18 b3]

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<sup>15</sup> Although it is critical to recognise already here that there is absolutely no guarantee that BT would price in this way – BT would only do so if such a pricing approach happened to be profit-maximising for them.

- 3.5.3 It is administratively simpler for Ofcom / BT (e.g. no need to derive cost forecasts for many individual products).
- 3.6 However, the downside of imposing (only) a basket charge control is, as Ofcom recognises, that BT is allowed a relatively wide degree of pricing flexibility which it might use in exploitative and exclusionary ways to increase its profits and reduce consumer and societal welfare. As an SMP operator BT is by definition capable of acting independently of competitors and therefore could recover more common cost from products that are purchased proportionately more by external customers (which could amount to harmful discrimination).<sup>1617</sup>
- 3.7 Such a pricing strategy is liable to create two economic inefficiencies:
- 3.7.1 First, BT is able to charge on average more than FAC for products that external customers purchase. In other words BT can set average external prices at an excessive level above the intended charge control level (the purpose of which is to align prices with efficient FAC over the charge control period).<sup>18</sup> In 'mathematical' terms the effect of this will be that external revenue will exceed external FAC; and
- 3.7.2 Second, it can create or exacerbate harmful discriminatory pricing (and a margin squeeze between wholesale and retail prices) since the prices that external customers pay will be on average above FAC and competitors will therefore be disadvantaged versus BT's downstream operations (who effectively pay BT's actually incurred cost). Such discriminatory prices can raise retail prices and/or weaken competition in the markets downstream from the wholesale market.
- 3.8 A separate concern is that BT could recover proportionately more common cost from less competitive products which could harm competition in the wholesale market e.g. wholesale AI services. As is outlined in the Alix Partners paper for UKCTA, if BT recover proportionately more common cost from less competitive products where BT has SMP then this can distort efficient competition and investment [see Alix Partners paper §§1.9-1.10].
- 3.9 Broad baskets such as the one that Ofcom proposes for Ethernet products allow BT substantial flexibility in the pricing of individual products. This flexibility could be used by BT to enhance welfare (by recovering more common cost from less elastic products). However, the danger is that the same flexibility could also be used to the detriment of competition and consumers by recovering more common cost from external customers and/or from less competitive products.

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<sup>16</sup> LLCC consultation document, paragraph 4.16.

<sup>17</sup> See also LLCC 2009 5.18 bullet 3.

<sup>18</sup> That these 'excessive' prices for external customers are offset by lower prices for internal customers is irrelevant since the internal revenue is not real. Though BT uses the same assets and/or products as external operators at notionally the same price, the charge they 'pay' is imaginary since there is no cash transaction or marginal impact. This is the case even where there is equivalence of input (EOI)

- 3.10 In our view Ofcom is wholly misguided in its view allowing BT the flexibility to price within a basket will mean that BT will price in a Ramsey efficient manner: “[with the basket] ... we would give Openreach the incentive to set prices and recover cost in the most efficient manner”.<sup>19</sup> BT does not set prices to be efficient, it sets prices to maximise its profits. BT is not some benevolent company who does what is best for consumers/society. It does what is best for its shareholders. Given that it does not operate in a competitive market the two are not aligned – in fact they are often diametrically opposed. Another passage that indicates Ofcom’s misunderstanding of BT’s incentives is at §6.48 where Ofcom says that: “We believe that [Ofcom’s approach] maintains a certain degree of flexibility for Openreach to balance charges and recover costs in the way that it judges to be efficient ...”. As well as illustrating again Ofcom’s misunderstanding of BT’s incentives this passage is an oxymoron. Efficiency is not a matter of judgement, it is a matter of fact.
- 3.11 Ramsey pricing can improve profits in an efficient way. However in this case the potential profit from ramsey pricing is low (since levels of price elasticity are fairly homogeneous and unknown by BT). Conversely, the profit potential from exploitative and exclusionary pricing is high since the basket is broad and heterogeneous. Therefore, BT’s profit maximising strategy will be to load costs on external customers resulting in reduced welfare or implement exclusionary pricing practices to deter entry into more competitive markets. The design of the price control must ensure that it minimises the risk of this happening over the price control period.

### 3.2 Addressing the disadvantages of charge control baskets

- 3.12 Ofcom has two conventionally-used tools at its disposal for tackling welfare detriming pricing behaviour by BT within a basket charge control. First, Ofcom can impose caps on individual products and/or sub-baskets that restrict the level of annual increases of individual products (referred to as ‘sub-caps’). Second Ofcom can apply a cost orientation obligation which in practice means setting a ceiling and floor for individual product prices (Ofcom typically use DSAC as the ceiling and DLRIC as the floor).
- 3.13 Though both tools provide some restriction on prices of individual products, they are very different in the nature of restriction they apply:
- 3.13.1 Sub-caps limit the rate at which prices can increase each year. They do not cap or restrict the absolute level of prices. They also do nothing to prevent existing excessive price levels at the outset of the price control period.<sup>20</sup>
- 3.13.2 Cost-orientation caps the individual level of prices (with reference to actual costs). However, they do not (by themselves) limit the rate of change of prices.

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<sup>19</sup> LLCC, §6.22.

<sup>20</sup> Further, sub-caps do nothing to prevent predatory prices (though this is of less concern in practice).

3.14 It is important to recognise that the ability of these measures to eliminate harmful or anti-competitive prices depends on the quantum:

3.14.1 How effective a sub-cap is will depend on how close the sub-cap X is to the X of the main cap. If the main cap is RPI-12% and the sub-cap RPI-9% then the sub-cap might be quite restrictive (allowing price rises only 3% above the average per year). In comparison, however, if the main cap is RPI-12% and the sub-cap is set at only RPI-2% then the sub-cap is not very constraining on prices;

3.14.2 How effective the cost orientation obligation depends on how far above FAC/LRIC+EPMU the ceiling is. By way of illustration DSAC is a pretty lax ceiling since it typically allows prices to increase to about twice FAC (or even higher than that).

3.15 We believe Ofcom should impose a stricter subcap (or set of subcaps) than that proposed and impose a cost-orientation obligation on Openreach.

### 3.3 The use of subcaps to constrain harmful or anticompetitive pricing

3.16 In the case of Ethernet services Ofcom has proposed a single basket for all AI services with the overall charge control set at RPI-12% with a subcap on every product at RPI-RPI.<sup>21</sup>

3.17 This can best be described as a pretty lax overall control since the basket is very broad and heterogeneous in that it includes products with very different characteristics (i.e. level of competition and relative use by external customers). In addition the general sub-cap is very weak (allowing about a 10 percentage unit variation versus average).<sup>22</sup>

3.18 We think that this structure has the potential to lead to significant harm in this case for the three reasons set out below.

3.19 First, there is limited profit opportunity from Ramsey-based pricing meaning that Bt is unlikely to pursue this approach:

3.19.1 The level of shared cost within the basket is limited. In particular, there is little common cost shared by access circuits and backhaul circuits since they use different parts of the duct/fibre network. It appears that Ofcom has not considered whether costs are common with other products within the basket but rather whether costs are common with other BT products.

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<sup>21</sup> The RPI – 12% cap on interconnection products (BTL) is pretty immaterial since the product volumes are expected to decline to zero by the end of the charge control period (LLCC consultation document, paragraph 6.38).

<sup>22</sup> We address the lack of cost-orientation in the following chapter.

- 3.19.2 The maximum Ramsey benefit is likely to be small since the associated relevant retail<sup>23</sup> price elasticities are not very different. Access AI products are used to deliver business leased lines whilst backhaul AI products are predominantly used to deliver residential broadband services. The difference in price elasticity between the two is likely to be small.
- 3.19.3 There is no evidence that Openreach (who set the prices) have access to the relevant retail price elasticity data for the products within the AI basket that would be necessary to be able to set Ramsey prices.
- 3.20 Second, and conversely as a result of the broad basket the products in the basket are very heterogeneous (in terms of competitive intensity and external vs internal use) meaning there is a high profit potential from exploitative and exclusionary pricing which means BT is likely to pursue this pricing strategy:
- 3.20.1 BT downstream divisions do not consume BES or, based on the RFS, EBD services.<sup>24</sup> In comparison, BT downstream divisions consume 63% of WES services (based on revenue) and 81% of EAD services. Also BT uses a comparatively larger number of lower bandwidth products.<sup>25</sup>
- 3.20.2 There are significant differences in competitive intensity across different bandwidths, access vs backhaul and different geographies (we do not have the precise data though from Ofcom's documents mention many differences)
- 3.21 Considering the case of pricing of backhaul (i.e. BES and EBD) within the Ethernet basket it is clear that there is potential for pricing that detracts welfare:
- 3.21.1 There is little potential efficiency from Ramsey pricing since backhaul products share little common cost with access AI products (they use different parts of the duct network)
- 3.21.2 There is large potential harm since (a) BT buy relatively little of them compared to access; and (b) they have a different competitive intensity compared to access.
- 3.22 Third, the sub-caps cannot prevent anti-competitive pricing rather they can only limit the rate at which prices can stray from cost and potentially become more anti-competitive. This is particularly so in this case where the sub-cap is so lax. The RPI-RPI cap on each product allows BT to increase relatively prices of some products by 50%.<sup>26</sup> Ofcom is simply wrong in its claims that sub-caps can "*prevent harm to competition*"<sup>27</sup> and that prices will be "*sufficiently constrained*" by the sub-caps

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<sup>23</sup> it is the retail price elasticity that is relevant in Ramsey pricing rather than the elasticity at the wholesale level *per se*

<sup>24</sup> Although the RFS shows that BT downstream divisions do not consume EBD we understand that BT do consume some EBD

<sup>25</sup> LLCC consultation document, §A5.173.

<sup>26</sup> For example: assuming RPI averages 2.5% then the average price will fall by 26% yet the price on any product(s) could be flat. In other words, assuming prices were aligned with FAC at the start then prices for some products could stray 35% above the average cost.

add explanation, assuming RPI 2.5% and use say 20% of products. An RPI – RPI cap may be reasonable where the X is (say) 6% but not where it is 12%

<sup>27</sup> LLCC consultation document, paragraph 4.19.

which renders it unnecessary to impose a cost orientation obligation.<sup>28</sup> Further it is important to recognise that just because the RPI-RPI sub-cap prevents price rises it does not mean it is satisfactory or is able to prevent exploitative / exclusionary prices. Exploitative / exclusionary prices arise where (average unit) prices diverge from costs. Where costs are falling rapidly (as in the case of Ethernet) a bar on price rises does little to prevent harm.

3.23 We think it is clear that in this case there is a significant risk of harmful pricing which the proposed subcap of RPI-RPI will not be able to prevent. It is therefore necessary to impose a set of stricter subcaps which we outline further below after we dealt with the need for a cost-orientation obligation.

### 3.4 The need for a cost-orientation obligation in addition to charge controls

3.24 Given the particular circumstances in this case (e.g. broad basket that contains heterogeneous products, little profit potential from Ramsey pricing), we believe there is a need to impose a cost-orientation obligation to guard against excessive (and indeed predatory) pricing.

3.25 The ability of a cost orientation to prevent excessive pricing is not just a theoretical argument. Indeed Ofcom has provisionally concluded that BT has overcharged for Ethernet services over a long period of time from 2006/7 to 2010/11 to the tune of more than £200m.<sup>29</sup> During this period, Ofcom also imposed charge controls on some of the services subject to dispute on 1 October 2009. These disputes therefore clearly show that a cost orientation obligation is necessary to guard against excessive pricing even when the SMP provider (in this case Openreach) is concurrently subject to a charge control.

3.26 Ofcom's reasoning to support abandoning the cost orientation obligation for Ethernet services is pretty scant – it comprises half a page [LLCC §6.113<sup>30</sup>] and much of that is spurious (e.g. reallocation of costs to AI). This lack of reasoning is very disappointing since the lack of cost orientation is a very significant departure from Ofcom's previous position.

3.27 Ofcom seems to rely on several points:

3.27.1 The impact of cost orientation obligations are uncertain since the actual DSAC costs and so allowable price levels are unpredictable [6.113 b1]. In contrast the impact of charge control/sub-caps is known in advance.

3.27.2 A cost orientation obligation is not very constraining since DSAC is far above FAC / LRIC+EPMU [6.113 b2]

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<sup>28</sup> LLCC consultation document, paragraph 5.12.

<sup>29</sup> Disputes between BT and each of Sky, TalkTalk, Virgin Media, Cable and Wireless and Verizon regarding Ethernet and WES services, Ofcom draft determinations, 9 February 2012, 22 February 2012 and 4 April 2012 respectively.

<sup>30</sup> This is in relation to AI services. A similar argument is replicated for TI services

- 3.27.3 Given the sub-caps a cost orientation obligation is simply ‘unnecessary’ [6.110, 6.113 b3] [6.112]
- 3.27.4 It would be “disproportionate” to impose a cost-orientation obligation alongside charge controls.<sup>31</sup>
- 3.28 We believe that some of these points are fundamentally wrong and, in any case, even if they were correct they would not collectively justify abandoning the application of a cost orientation obligation.
- 3.29 With regard to Ofcom’s ‘unpredictability’ point:
- 3.29.1 Although BT can only know precise DSAC figures ex post it can reasonably estimate these within +/- a few percentage points in advance based on previous years DSAC and forecast cost trends (which it estimates as part of its management planning process)
- 3.29.2 Ofcom’s unpredictability point is based on Ofcom’s current interpretation of cost orientation i.e. DSAC as the ceiling. There are alternative interpretations (such as the ceiling being FAC+30%) which are far more predictable than DSAC and the policy project is considering what the appropriate ceiling should be.
- 3.29.3 Ofcom seems to think that rival CPs consider that cost orientation obligations are ineffective since they are uncertain. This is not correct. Although the exact impact of a cost orientation obligation are relatively less certain, it provides a level of reassurance that prices over time move reasonably in relation to cost. We believe providers therefore are very keen to retain the cost-orientation obligation.
- 3.30 With regard to Ofcom’s ‘not very constraining’ point:
- 3.30.1 We agree with Ofcom that the current DSAC ceilings are inappropriately high and therefore would allow BT to earn excessive returns. However, even if a DSAC ceiling was retained it is better than no ceiling at all.
- 3.30.2 In any event, this lax ceiling is based on Ofcom’s current interpretation of cost orientation and the policy project is considering what the appropriate ceiling should be to be meaningful and effective.
- 3.31 Regarding Ofcom’s ‘unnecessary’ point:
- 3.31.1 As we explained above, sub-caps do not put constraints on BT’s prices (as to how they relate to actual costs) but merely the rate at which they change. Therefore, we fail to see how Ofcom can conclude that a cost orientation conditions is ‘unnecessary’.
- 3.31.2 Further, the heterogeneity in the broad basket increases the incentive on BT to price anti-competitively and so the need for additional pricing constraints.

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<sup>31</sup> LLCC consultation document, §6.114.

- 3.32 With regard to Ofcom's point about a cost orientation obligation being 'disproportionate':
- 3.32.1 We do not quite understand what Ofcom means but we imagine that this might mean the benefits do not outweigh the costs. If this is what Ofcom means then we fundamentally disagree since there will be significant benefits yet the costs will be small or zero. In any case, the conclusion of what is proportionate or disproportionate must be made with regard to what one is trying to achieve.
  - 3.32.2 Here the objective must surely be to ensure that BT does not adopt any form anti-competitive pricing strategy and the only way to achieve this is in our view to impose a cost-orientation obligation since sub-caps alone are plainly not able to prevent excessive pricing of individual products within the basket (as explained above).
  - 3.32.3 As to the costs on BT of imposing a cost orientation obligation, we believe these must be regarded as trivial. The administrative costs are small and it is difficult to see how a cost-orientation obligation could prevent BT from adopting any form of legitimate welfare enhancing pricing (which would be a cost to be considered).
- 3.33 We are highly concerned that Ofcom's proposal on whether to apply cost orientation is based on an interpretation of cost orientation that was developed 15 years ago for voice interconnect services – i.e. DSAC ceiling and DLRIC floor. Since Ofcom is consulting on what the ceiling and floor should be in future it seems wholly inappropriate to rely on the current interpretation when considering whether to apply cost orientation.
- 3.34 We note that Ofcom has not considered the general efficiency impacts of applying a cost orientation condition which links prices to actual costs. We consider that the obligation can enhance allocative efficiency but (given that it is imposed within a basket structure) it will not create the normal downside of linking prices to actual costs which is to weaken cost minimisation incentives:
- 3.34.1 Cost orientation can (to some degree) improve allocative efficiency since prices are more closely related to actual cost. In contrast, under a charge control, if forecasts are poor, the allowed prices (based on forecast costs) can diverge from actual costs resulting in allocative inefficiency.
  - 3.34.2 The imposition of a cost-orientation obligation will not reduce or weaken the incentive on BT to minimise costs for AI services (for instance because it would somehow be required to pass through automatically any marginal cost reductions based on actual rather than forecast costs). This argument equates cost-orientation to 'rate of return regulation' (where prices are set to equal actual costs) which in this case it is not. The cost orientation obligation would only require a price reduction if prices were at or near the ceiling and therefore in most cases a reduction in actual costs would not lead to a need to reduce prices. Even if the price for particular product were at the ceiling, a cost reduction would not lead to a net price reduction. This is because (due to the nature of the basket) a reduction in price of one product

could be fully offset by a reduction in the price of another product (subject of course to any meaningful subcaps).

### 3.5 Suggested format of price regulation

3.35 There are a number of ways in which the concerns that we have articulated above can be addressed. For instance, one might impose individual product charge controls or several narrower (and so more homogenous) baskets or tighter sub-caps. All of these solutions have advantages and disadvantages.

3.36 Taking all things into consideration, we consider that a balanced and pragmatic approach would be as follows:

3.36.1 Retain the same single charge control of RPI-12% over the same (very) broad basket;

3.36.2 Create a separate sub-cap on a basket consisting of BES and EBD services set at RPI-8%<sup>32</sup>. Such a sub-cap would ensure that Openreach does not distort competition by failing to reduce prices for BES/EBD services (which BT downstream services consume comparatively less) by less than other products (which BT downstream services consumer comparatively more). It would also allow BT the flexibility to rebalance prices between old and new backhaul technology to encourage migration; and

3.36.3 Set the general sub-cap (i.e. on all products) at RPI-6% (since an RPI-RPI cap is far too lax and does not prevent harmful pricing by BT); and

3.36.4 Impose a cost orientation obligation which addresses the specific concerns over excessive pricing for individual services in an effective and proportionate manner;

3.36.5 Consider whether there is a mechanism that would prevent Openreach targeting price reductions on downstream divisions disproportionately more than external customers. For instance, Ofcom could require that BT publish (in its RFS) the average annual price rise for internal services and external services.

3.37 In our view this package of measures would allow the necessary level of flexibility for legitimate pricing purposes (i.e. Ramsey pricing and encouraging migration) but restrict anti-competitive pricing (loading cost onto external customers and less competitive markets).

### 3.6 AI in WECLA pricing

3.38 Ofcom is proposing a 'safeguard' cap of RPI-RPI for the prices of AI services (<1Gbps) in WECLA which they consider sound since it will prevent prices increasing. We

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<sup>32</sup> Ofcom have rejected a sub-cap on BES products since it would prevent pricing to encourage efficient migration [6.54]. We accept that logic. However, that logic does not apply to a BES/EBD basket.

understand and support the need for lighter controls in WECLA (where there is more competition and more potential competition) than outside WECLA but we find the specific cap too lax.

- 3.39 Our understanding is that prices in WECLA are generally the same as outside WECLA. Given the higher density in WECLA it is likely that unit costs (e.g. FAC) in WECLA are lower than outside WECLA. This means that profits on WECLA AI services is currently higher than non-WECLA AI services. Yet under the charge controls WECLA AI service prices will fall at 0% per year whereas non-WECLA AI services will fall at 9% a year which will tend to allow the difference in profits to increase.
- 3.40 We consider that given BT has SMP and so can act to some degree independent of competition that a tighter constraint is required. We suggest an RPI-6% cap which will still leave ample room for competition to develop
- 3.41 We note that Ofcom says that RPI-RPI is an effective ceiling since it prevents prices from increasing [LLCC §8.14]. Whether prices increase is not directly relevant but rather how they move relative to costs. For example if costs are falling at 10% then a 'ceiling' that prevents price rises is effectively a 'rising ceiling' and so will become less and less effective.

### 3.7 Relationship to cost orientation / RFS policy project

- 3.42 We are concerned about the relationship between the BCMR proposals (and in particular the proposal not to impose a cost-orientation obligation) and Ofcom's policy project reviewing the purpose and application of cost-orientation obligations on an SMP provider and the related subject of the provision of regulatory financial data.
- 3.43 Ofcom has, for the past 12 months, been running a policy project assessing whether and where cost orientation obligations should apply and if so how they should be interpreted. In parallel with this policy project, Ofcom has also been assessing what regulatory financial data should be provided. There was a call for inputs to this project in November 2011 according to which Ofcom expected to complete the project (aside of implementation) by autumn of 2012.<sup>33</sup> TalkTalk, along with other stakeholders, has inputted a large amount of evidence and views into this review. However, we understand there has now been a substantial delay to the project and that a first consultation (but possibly not even covering the subject of cost orientation) might not be published until September 2012.
- 3.44 We are concerned that the approach taken by Ofcom in its leased line charge control proposals has effectively superseded the role and purpose of the policy project. It seems to us that through these proposals Ofcom has decided that the most appropriate way of imposing price regulation does not include the imposition of a cost-orientation obligation or a requirement disclose certain critical regulatory

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<sup>33</sup> Review of cost orientation and regulatory financial reporting in telecoms Call for inputs 8 November 2011 §1.8.

financial information. This is problematic in our view because Ofcom's reasoning in the BCMR/LLCC to not impose cost orientation obligations is substantially less (and inadequately) well reasoned than that put forward in the policy project. By way of example, the reasoning to abandon the cost orientation obligation (for AI) is about half a page [LLCC §6.113] much of which is spurious and does not even touch on critical issues such as how much pricing flexibility BT legitimately needs. Further, Ofcom does not seem to have taken into account the substantial views and evidence that has been provided by stakeholders into the policy project.<sup>34</sup> Ofcom certainly have not responded to the points raised in the policy project. It seems to us that the BCMR/LLCC work is being conducted independently of the 'policy' project.

3.45 We believe Ofcom is 'putting the cart before the horse' by resolving the policy issues around cost-orientation in this market review rather than, as would be appropriate, in the policy project.

3.46 One good example of the rather perverse approach that Ofcom is taking is the following: Ofcom's (scant) reasoning for not imposing a cost orientation obligation includes that (under the current 15 year old interpretation of cost orientation) the allowable prices are uncertain and are not very constraining [LLCC §6.113]. That might be so. But the solution is not to remove the cost orientation obligation but rather to update the interpretation so that the allowed prices are more predictable and properly constraining on the SMP provider. This is exactly what the policy project is looking at and something that must be taken into account in the leased lined charge control proposals.

3.47 By failing to apply a cost orientation obligation on Ethernet services as part of this market review, Ofcom will not be able to impose a better and more effective form of such an obligation as a result of the outcome of the policy review. It would be far better to leave the cost orientation obligation in place and then for Ofcom to update its interpretation in the policy project (both the interpretation generally as well as, if need be, in the specific case of leased lines).

3.48 Finally, we have a related concern about Ofcom's approach to its proposal for cost orientation in the BCMR. Ofcom sometimes has a tendency to prefer consistency and so might, in other market reviews, adopt the approach that has been followed in the BCMR. This would mean that the BCMR project would dictate Ofcom-wide policy yet will have not have taken into account the inputs of all the stakeholders affected nor would have properly considered the full range of issues. This reinforces the importance of resolving questions around when/where to apply cost orientation in a well-reasoned and focussed policy project and not change Ofcom's approach on basis of a scant and cursory analysis in one market review.

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<sup>34</sup> TalkTalk's response to the call for inputs (as well as that of other stakeholders) can be found at: <http://stakeholders.ofcom.org.uk/consultations/cost-orientation-telecoms/?showResponses=true>

### 3.8 Accounting transparency obligations

3.49 We also note in the context of cost orientation that Ofcom has proposed to reduce the accounting transparency obligation on BT in respect of products in the business connectivity markets since no cost orientation obligations apply [BCMR 15.12]. It is not quite clear what data will no longer be available but we imagine that this means that FAC, DLRIC and DSAC data for groups of different (say) AI products will no longer be published. It seems Ofcom's view is that the removal of a cost orientation obligation is naturally followed by the removal of certain regulatory accounting obligations.

3.50 Removing this data will make it impossible for stakeholders and customers to see how the prices they pay relate to cost. This means that BT could distort prices within the basket (e.g. by loading price increases onto externally purchased products) but for this distortion versus cost not to be visible.

3.51 Such a situation would in our view be intolerable and unacceptable. Whether or not a cost orientation obligation applies or not stakeholders and customers must be able to see how prices relate to cost<sup>35</sup>. We see no meaningful cost or harm (apart from a small administrative burden on BT) from making this information available.

3.52 In respect of accounting transparency information, we would also note that Ofcom considers that accounting transparency can demonstrate if BT is price discriminating – for example:

*It is essential, if the obligation to not unduly discriminate is to be meaningful, that BT and KCOM can be required to make transparent its wholesale prices and internal transfer prices, i.e., to demonstrate that they are not unduly discriminating against CPs. In practice this means that they are obliged to produce financial statements that reflect the performance of markets as though they were separate businesses. Accounting separation therefore enables Ofcom to monitor whether BT or KCOM are unduly discriminating.*  
[BCMR §15.9]

3.53 We consider that internal transfer prices are in reality meaningless. They are 'what they say on the tin' i.e. internal transfer prices – they are not a genuine cost to the downstream business or revenue to the upstream business and do not, for example, affect the way the downstream business sets its retail prices. Thus the fact that the external wholesale prices and internal transfer prices are the same or similar says nothing about discrimination or any other form of anti-competitive behaviour such as there being a margin squeeze or not.

### 3.9 Removal of requirement for charge to be 'fair and reasonable'

3.54 In the previous BCMR there was an SMP Condition that required prices to be 'fair and reasonable'. However, though there is a similar requirement in this BCMR for

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<sup>35</sup> It is also valuable to understand how BT allocates costs under its FAC methodology (notwithstanding that prices might not be set with reference to FAC costs).

terms to be 'fair and reasonable' it explicitly excludes the need for charges to be fair and reasonable (SMP Condition 1).

- 3.55 This is yet another weakening of the restrictions on BT's pricing to prevent anti-competitive behaviour by BT. Previously there has been a charge control and cost orientation obligation and 'fair and reasonable' obligation. Now, seemingly driven by the vague (and flawed) logic of 'proportionality' Ofcom is proposing dropping two-thirds of the obligations on BT.
- 3.56 It is somewhat ironic that Ofcom identifies the potential problems of margin squeeze, price discrimination and predatory pricing (for example, Table 84) and then does nothing to prevent them.

## 4 Passive remedies - dark fibre and PIA

4.1 Ofcom has provisionally concluded that passive upstream remedies to the business connectivity market – particularly dark fibre and PIA (passive infrastructure access i.e. duct access and pole access) – should not be mandated. PIA is a mandated remedy in the WBA market (to allow competitors to develop rival NGA networks) but Openreach have intentionally and explicitly prevented PIA being used for leased lines. We discuss both these remedies in this section since they share similar issues.

4.2 Upstream passive remedies have been highly successful in other markets – in particular, LLU (the copper equivalent of dark fibre) was absolutely instrumental in driving increased competition and uptake in the residential access and broadband markets (even though downstream active remedies existed). Allowing such ‘deep’ competition exposes more of the value chain to competition and innovation. The policy of supporting deep competition has been the central bedrock of Ofcom’s policy. Ofcom recognises the benefits that upstream / passive remedies can deliver in the context of wholesale leased line (for instance from BCMR §§8.58, 8.59, 8.43, 8.93):

*Requiring BT to share its physical infrastructure by imposing passive remedies, such as PIA or dark fibre, could stimulate competition by lowering barriers to entry for competitors who invest in infrastructure.*

*Whereas a PIA remedy may deliver increased investment in fibre, either PIA or a dark fibre remedy may deliver other important benefits, such as increased investment in fibre-based services, more innovation and greater choice for customers.*

*We recognise that it is possible that passive remedies could improve the prospects for competition generally,*

*We recognise that benefits to consumers and to competition could be achieved by imposing passive remedies on BT to offer Sky and others options for implementing backhaul in certain routes.*

4.3 In particular, in the case of AISBO and MISBO services (both access and backhaul), passive remedies would allow other operators to deploy their own electronic (or active) equipment and not rely on Openreach. Competition at this ‘active’ layer has the potential to deliver significant consumer benefits since:

4.3.1 There is significant innovation at this layer. The key active layer technology has evolved from PDH to SDH to 1<sup>st</sup> gen Ethernet to 2<sup>nd</sup> gen Ethernet to WDM and further innovation is likely e.g. new optical technologies, aggregation, Sync-E

4.3.2 It represents a large portion of the total cost – perhaps 30%<sup>36</sup>

4.4 Even though there are significant potential benefits, Ofcom has rejected mandating these remedies since it sees “*significant risks*” – these appear to be:

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<sup>36</sup> This is a best guess from RFS since BT/Ofcom has not disclosed the actual figures.

- 4.4.1 Competitive entry could be ‘inefficient’ and ‘duplicative’ [BCMR §§1.37, 8.60, 8.87, 8.94]
- 4.4.2 Similar benefits can be achieved by downstream active remedies (i.e. AI products) [BCMR §§8.93, 8.94 b1]
- 4.4.3 BT has now almost caught up with most product development requirements [BCMR §§8.56, 8.85]
- 4.4.4 Competitors would focus only on more profitable uses (e.g. higher bandwidths in urban areas) which would result in higher prices elsewhere and for other services through two effects [BCMR §8.64]: “[competitors] *may not be sustainable outside some dense geographic clusters of businesses, such as major urban centres.*” [BCMR §8.61]:
  - 4.4.4.1 Openreach would be left serving the higher cost customers/areas [BCMR §8.62]
  - 4.4.4.2 It would ‘defeat’ the currently high recovery of common cost from higher bandwidth services [BCMR §8.63]
- 4.4.5 Ofcom has not been presented with solid evidence of demand for PIA/dark fibre [1.40] or evidence that (in the case of PIA) lifting the restriction will trigger investment in competitive NGA [BCMR §8.89]
- 4.5 We consider that many of these points are incorrect and even if they were correct they would not together provide a sound or cogent reason to not mandate passive remedies.
- 4.6 Our first concern with Ofcom’s reasoning (in first two points) is that it seems to be based on a belief that a market left to its own devices will make inefficient investment or investments that are not beneficial and then that Ofcom should decide what investment is efficient (by restricting the options open to BT’s rivals). This is plainly nonsense: competitive investment will only generally occur if investors see a potential cost saving (i.e. greater efficiency) and/or it delivers innovation benefits over using the wholesale product and that these benefits are sustainable. Competitor investors do not make investments that make no commercial sense and do not deliver consumer benefits<sup>37</sup>.
- 4.7 Ofcom’s reasoning seems to imply that it knows better than private investors what investment is good or bad and that its role is to decide on what investment can and can’t be made. If that is Ofcom’s view then Ofcom is wrong. Ofcom’s role is not to decide where investment cannot happen – it simply lacks the evidence and data. Instead, Ofcom’s role is to give competitors the options and opportunities and let them invest in a competitive market as they see fit.
- 4.8 Regarding the duplication question it is worth noting that much of the competitive investment (particular in the case of dark fibre) is not duplicative since it is dedicated

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<sup>37</sup> This may be some conditions for this – for instance, that wholesale prices are not distorted e.g. price differences at least as great as LRIC cost differences.

to the particular customer e.g. CPE on customer premise<sup>38</sup>. Further, passive remedies might actually avoid duplicative investment since operators such as Geo and C&W who build duct today to provide leased lines would be able to avoid that duplicative duct cost by using dark fibre and/or PIA.

4.9 We find Ofcom's complaints that allowing these remedies will only be effective for certain geographies/products/customers and will result in higher prices as puzzling and ultimately misplaced and wrong:

4.9.1 It is the very nature of telecoms that the level of competition varies e.g. by geography, by customer group – for example different geographies in BCMR and WBA, broadband versus line rental, analogue vs >1Gbps leased lines. It cannot be legitimate to prevent competition in one area/product since it won't work everywhere<sup>39</sup>.

4.9.2 We consider that Ofcom's concerns about competition resulting in higher prices elsewhere as misplaced. Effectively what Ofcom seems to be troubled about is that competitors will target lower cost customers/areas and so Openreach's average costs will rise resulting in lower prices in competitive areas and higher prices in non-competitive areas. If this happens it will be efficient since in both areas prices will be set closer to cost thereby increasing allocative efficiency. Therefore, we cannot understand Ofcom's concern about the price changes that will result from competition. Ofcom's concern seems an attack on the very essence of competition. This type of price change (lower prices in competitive areas and higher prices in non-competitive areas) is exactly what has happened in telecom markets e.g. WBA (e.g. market 1) and BCMR (e.g. outside WECLA) – we fail to see why it is a problem. In fact, it is exactly the opposite – it is beneficial<sup>40</sup>

4.9.3 With regard to competition defeating Openreach's higher common cost recovery on higher bandwidth service, Ofcom seems to suggest that deep competition will lead to losses in economic inefficiency. However, this would only be the case if Openreach's current pattern of common cost recovery (where for example high bandwidth circuits recover more common cost) was in fact economically efficient. However, this is unlikely to be the case:

4.9.3.1 Ofcom has provided no evidence to demonstrate that BT's common cost recovery is in fact efficient and that an alternative would be less efficient

4.9.3.2 Ofcom cannot presume that Openreach are Ramsey pricing i.e. recovering common costs from lower elasticity products. There are other profit-maximising reasons that drive BT's common cost

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<sup>38</sup> The example of the level of duplication in NGA that Ofcom uses is plainly a very poor analogy since (for instance) it assumes I believe that each operator deployed their own duct, fibre and cabinet.

<sup>39</sup> It is worth noting that in the early days it was thought LLU would only be used in 500 or so exchanges covering 30% to 40% of the UK i.e. only urban areas and over time it has expanded out to over 2,500 exchanges covering about 93%.

<sup>40</sup> The only case where these changes in prices might be inefficient would be if there were an equity or distributional reason to justify subsidies (e.g. reducing digital divide). However, Ofcom has not advanced any arguments regarding equity/distribution

recovery across different products particularly BT's own relative internal use and competitive intensity (as described above). In any case, even if these factors were absent (which they are clearly not) it is not obvious that BT would Ramsey price since this may not be the profit maximising strategy and further they lack the elasticity information to set efficient prices

4.9.3.3 In fact Ofcom itself accepts that it is not sure that BT's pattern of common cost recovery is efficient: *"Allowing for an upward-sloping bandwidth gradient (i.e. higher costs for more capacity) may be an efficient way to recover fixed and common costs ..."*

4.10 Regarding BT catching up with the demanded innovation it might be correct that BT is getting better. However, what is relevant is the future not the past and unequivocally the best way of ensuring that innovations are brought to market in an efficient / timely manner is to allow competition to set the pace. Even though we have seen significant innovation in the last five years (2<sup>nd</sup> generation Ethernet, WDM) there will be more innovation in the future and after that yet more. If passive remedies are not mandated then innovation will continue to be at the behest of the monopoly Openreach.

4.11 Regarding the lack of firm evidence of demand for PIA<sup>41</sup>/dark fibre we accept that there is not a water-tight business/economic case<sup>42</sup> on the table from an Altnet that shows a demand for large volumes of PIA and/or dark fibre<sup>43</sup>. However, this should not mean Ofcom does nothing – uncertainty is not in this case any reason for inaction.

4.11.1 Either there will be demand in which case there will be economic benefits from competitive investment leading to more choice, lower costs, lower prices and more innovation

4.11.2 Or there will not be demand in which case the economic cost will be minimal. In the case of PIA the only cost will be the small cost of removing the artificial restriction in the PIA contract whereas in the case of dark fibre the cost might be a few £ million in developing the product (since unlikely to be an equivalence of input implementation)

4.12 Ofcom's approach seems to be founded in an 'industrial policy' frame of mind where it does not trust the market to deliver an efficient outcome and so it is actively restricting competition.

## 5 Ironically, the same criticisms that Ofcom is now levelling at PIA/dark fibre were levelled at LLU (by BT)

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<sup>41</sup> In respect of use of PIA for NGA roll-out this has been effectively hampered because BDUK has only approved two bidders BT and Fujitsu and currently Fujitsu has won none of the bids

<sup>42</sup> the benefit is both the benefit in the business connectivity market as well as the WBA market (not as Ofcom seems to suggest the WBA market only)

<sup>43</sup> neither was there a water-tight business case on the table when Ofcom embarked on driving LLU

in the early 2000s<sup>44</sup>. Indeed, if Ofcom had applied the same logic to LLU as it is now applying to PIA/dark fibre (duplication cost etc) then Ofcom would never had embarked on encouraging LLU and we would have still be in a world where WBA as the only effective way of delivering broadband.

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<sup>44</sup> Rather oddly, the language and reasoning Ofcom uses is similar to that which BT uses to argue against the introduction of LLU and which Ofcom squarely rejected e.g. we BT is a good monopoly, competition will result in duplication, competition will not be universal and so is bad, prices for some customers might rise

## Ethernet charge control

- 5.1 In this section we comment on certain specific aspects of the proposed charge control for Ethernet (other than the issues of sub-caps and cost-orientation addressed above), including:
- 5.1.1 application of the MEA and the £43m migration credit;
  - 5.1.2 key allocation and forecast assumptions such as the TI-to-Ethernet cost reallocation, efficiency assumptions and cost of capital assumptions; and
  - 5.1.3 design elements such as starting year adjustments and geographic discounts.

### 5.1 MEA approach for Ethernet services and migration credit

- 5.2 We support Ofcom's proposal to move to an MEA approach when setting the charge controls for Ethernet services. In practice Ofcom proposes to consider that the technology which Ethernet services (EAD and EBD) are based on constitute the MEA and that their underlying cost of provisioning should be used as a basis for modelling the costs of all services in the charge control. Clearly, any case to not use the MEA since it was unknown or unpredictable has disappeared since Openreach is clearly already well-advanced in its programme to migrate Ethernet services to EAD and EBD. Further, Openreach has announced the withdrawal of WES, WEES and BES up to and including 1Gbit/s<sup>45</sup> and Openreach is also planning to announce the withdrawal of WES and BES services over 1Gbit/s as from August 2013.<sup>46</sup>
- 5.3 We note that Ofcom claims that an anchor based approach gives BT strong incentives to reduce costs: "*... the use of anchor pricing will tend to be consistent with efficient investment incentives.*" [LLCC 4.71] We consider this wrong<sup>47</sup>. The MEA approach will provide a stronger incentive on BT to move to the next generation of Ethernet services than the anchor-based pricing approach. BT's incentives to minimise costs will be strongest when prices are set independent of BT's actual costs – under anchor pricing prices are set with reference to the technology BT happens to be using whereas under an MEA approach prices are set based on the most efficient technology irrespective of what BT is doing. The CC agrees with this:

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<sup>45</sup> LLCC consultation document, §6.76.

<sup>46</sup> Openreach slidepack for Ethernet Product and Commercial Group, 21 August 2012.

<sup>47</sup> We consider that Ofcom's attempt to justify its use of anchor pricing in the 2009 LLCC is rather implausible. Ofcom says there were four reasons [LLCC §6.71] for adopting the anchor pricing approach (it called it 'technology neutral' approach at that time) and refers to §3.77-§3.107 of the 2009 LLCC. In fact, the 2009 LLCC only mentions one of these points in this section (practicality/data availability). Further, the other three points Ofcom raises in §6.71 are not valid:

- Ofcom could have adopted the MEA and allowed BT to recover relevant costs (e.g. by allowing a 'migration credit'). In any case, arguably BT would not have to recover since it was allowed a high cost of capital

- Using the MEA would provide more incentive to invest efficiently than anchor pricing

- Pricing flexibility has nothing to do with how costs are set

It is a little disappointing that Ofcom cannot be straightforward about its reasoning.

*“... whilst we agree with CPW that, generally, incentives are strongest when price controls are set independently of actual behaviour or performance, in practice, regulators are frequently required to strike a balance between maintaining incentives and the need periodically to reset charges so as to ensure that they allow firms to recover efficiently-incurred costs or consumers do not pay excessive prices.”<sup>48</sup>*

In other words the CC accepts the principle that cost minimisation incentives are strongest when prices set independently of BT’s behaviour and costs but for other reasons Ofcom may set prices on the basis of BT’s costs.

5.4 Whilst we agree with the use of the MEA, we believe there is a difference between what is considered to be MEA technology and whether this has been adopted in an efficient manner. In this vein, we are concerned that Ofcom appears to accept that Openreach is adopting EAD and EBD in an efficient manner. This is not a question about Openreach’s operating efficiency (which we comment specifically upon below) but whether Openreach’s cost stack for EAD and EBD can be considered efficient on an objective basis.

5.5 There are two ways to address this important issue:

5.5.1 First, we believe Ofcom must challenge Openreach to show that its deployment of EAD and EBD is efficient over the period of the charge control. It is rather obvious in our view that EAD and EBD technology will become more efficient (e.g. improved productivity<sup>49</sup>) over the charge control period and Ofcom must therefore apply a suitable capital cost efficiency factor in its forecasting assumptions. We would suggest this is the conventional approach when setting charge controls. It is incorrect to simply assume (as Ofcom seemingly has done) that existing EAD/EDB technology and equipment (and its costs) will not become more efficient over the charge control period. We address this point further in section 5.2.4 below.

5.5.2 Alternatively, or even additionally, Ofcom could seek to build a bottom-up model to verify Openreach’s cost of delivery and whether it is as efficient as it could be. We note that the overall impact of adopting the MEA approach (combined with the migration credit which reduces the saving) is an X that is 1.0% higher.<sup>50</sup> In other words the overall impact of adopting the MEA is that costs are 3% lower in 2015/16 than they otherwise would have been. Instinctively this feels low. Presuming a 3% cost reduction from a move to more efficient second generation Ethernet does not seem like a tough requirement.

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<sup>48</sup> The Carphone Warehouse Group plc v Office of Communications Case 1111/3/3/09 LLU Determination §3.41

<sup>49</sup> We note that Ofcom applies a real price reduction (RPI-3.6%) to unit equipment costs – see LLCC Table A5.13.

<sup>50</sup> LLCC consultation document, Table 6.11.

5.6 Either way, Ofcom must ensure that it has objectively verified that BT's MEA costs in 2015/16 are efficient.<sup>51</sup>

### 5.1.1 Migration credit

5.7 Ofcom proposes to grant BT a "migration credit" of £43million to "account for the costs of transition to a more efficient network".<sup>52</sup> We consider that it is right in principle to acknowledge that a provider will incur costs as a direct result of moving to MEA technology<sup>53</sup>. However, we believe Ofcom has failed to take into account the following considerations:

5.7.1 First, as mentioned above, Openreach has already taken the commercial decision to withdraw all WES and BES services from new supply. We would suggest that an organisation operating in a competitive market would only take such a decision if it considered that it would be able to migrate such legacy customers onto more efficient technology at some point. In other words, such migration plans would form part of the same business plan. Ofcom notes that Openreach has already offered reductions on EAD connections fees for CPs migrating from legacy Ethernet products.<sup>54</sup> Any migration credit should exclude any such or similar migration incentives that Openreach has already implemented (or considered implementing in internal business plans).

5.7.2 Second, the calculation of the migration credit assumes that all legacy Ethernet circuits will be migrated during the course of the charge control period. The migration credit should therefore be considered "full and final". In other words, Openreach should not be granted any further migration credits in future charge controls if it has, for whatever reason, failed to migrate all Ethernet services to EAD and EBD by the end of the charge control period.

5.7.3 Third, we are also concerned that Openreach will have an incentive to favour BT downstream divisions when implementing any migration incentives (in a similar fashion to the incentive they have to set lower prices for products used disproportionately more by BT downstream divisions). For instance, Openreach would have a much greater incentive to reduce migration costs from WES services (which BT downstream divisions use) rather than migration costs from BES services (which BT does not use itself). Ofcom

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<sup>51</sup> As an aside, we note that Ofcom seem to equate MEA and CCA [see LLCC 4.57]. Though there are some similarities and cross-over they are very different concepts. The MEA is about basing costs on the costs of the modern technology (rather than legacy). CCA is about whether asset valuation is derived using units costs (of whatever technology) that pertained at the point the equipment was made (HCA) or based on current prices (CCA). Thus you can assume the MEA technology but value it at CCA or HCA prices and similarly you can assume use of the legacy technology but value it at CCA or HCA prices.

<sup>52</sup> LLCC consultation document, §6.102.

<sup>53</sup> Allowing a migration credit is akin to allowing implementation costs for achieving efficiency gains

<sup>54</sup> LLCC consultation document, footnote 205.

should therefore require Openreach to guarantee that any such discrimination does not emerge over the charge control period. This could be achieved by a compliance statement that shows how much discount was provided to BT and how much to non-BT (and how this compares to the legacy base of revenues)

- 5.7.4 Fourth, BT is already handsomely compensated for the possibility of technology obsolescence and/or stranded assets since its cost of capital includes a significant risk premium – over the last 5 years the additional revenue it has been allowed is around £100m<sup>55</sup>. Therefore, it is not necessary for the charge control to fully allow recovery of assets whose value reduces (i.e. holding losses) since this will result in double recovery
- 5.7.5 Fifth, it seems that the way the £43m is calculated and applied is incorrect. It appears that the £43m is the amount that Openreach needs to offer in totality to its customers to encourage them to move to the MEA. The £43m is deducted from the 2015/16 revenue (or added to the cost) resulting in a higher X and so allowing revenues to be £43m higher in 2015/16 (than they otherwise would have been). However, this will also mean that revenues are higher (than they otherwise would have been) in 2013/14 (by £14m) and 2014/15 (by £29m) as a result of the way the glidepath operates and also higher in 2016/17 and 2017/18. Thus in total by deducting the £43m migration credit from 2015/16 revenues, BT will increase revenues by a total of £129m. This appears to be an error.
- 5.7.6 Sixth, the migration credits must not count towards achieving the RPI-X charge control. If they did then BT would be able to over-recover.

## 5.2 Cost allocations and forecasts

- 5.8 In this section we comment on a number of allocation and forecast assumptions that Ofcom has made namely: reallocation of £101m to Ethernet; RAV adjustment; capex efficiencies; operating cost efficiencies; and cost of capital.

### 5.2.1 Reallocation of £101million in common costs from TI to Ethernet

- 5.9 Ofcom proposes a cost reallocation from TI to Ethernet of £101m (equal to £46m in capital costs and £55m in operating costs). The justification for this reallocation is that the cost allocation model used by BT will not take into account the fact that the underlying cost components for TI and Ethernet services use the same underlying assets. As TI volumes are expected to fall and Ethernet volumes grow over the charge control period, the unit costs for TI would increase disproportionately because smaller TI volumes would still need to be recovered over the same cost pool. The proposed reallocation from TI to Ethernet is intended to fix this problem in

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<sup>55</sup> Current MCE about £1bn (see Table A5.5). Risk premium is about 4% (see Table A4.71) and assume that half of it (i.e. 2%) relates to asset stranding. Thus premium for risk of asset stranding is about £20m per year (2% x £1bn) and £100m over 5 years

the underlying cost model by allocating an amount that would mean that the resulting TI unit costs remain stable in real terms.

- 5.10 The proposed reallocation significantly increases Ethernet costs by about 20% which in turn reduces the proposed X value in the charge control from RPI-17.5% to RPI-12.0%.
- 5.11 TalkTalk has commissioned a report from Frontier Economics to review the proposed allocation methodology. A copy of the Frontier report is enclosed. The report concludes that there are a number of potential flaws in the approach suggested by Ofcom (which would, if corrected, lead to a lower cost reallocation):
- 5.11.1 Ofcom's assumption that TISBO unit capital costs are stable is unrealistic. On the contrary, it is reasonable to expect that TISBO unit costs would rise over time due to dis-economies of scale and reductions in utilisation (as TI volumes fall). For example, BT argued that the floor space required for certain elements of TI equipment would remain the same as demand fell based on empirical evidence.<sup>56</sup> However, utilisation of resources such as duct and accommodation by TISBO services would not be expected to fall as rapidly as demand, leading to increases in unit costs.
- 5.11.2 Ofcom's methodology incorrectly assumes that the TISBO common costs are common to only TISBO and AISBO services alone. A number of the underlying assets and activities, for example duct and accommodation, are not specific to leased line services but are shared over almost the full range of communications services provided by BT. This is borne out by the RFS. Thus reductions in the cost of these assets and activities recovered from TISBO service could be recovered across all of the other services using these assets and activities, not just AISBO services.
- 5.11.3 Ofcom's methodology takes no account of changes in demand for AISBO services. While there will be some direct substitution of TISBO services by AISBO services, Ofcom has presented no evidence to support its assumption that all reductions in TISBO services will be directly offset by increases in AISBO services and so appropriate for AISBO to pick up all of the recovery.
- 5.11.4 Ofcom's methodology takes no account of the lower resource usage by AISBO than TISBO services. AISBO services will make more efficient use of resources such as floor space, power, duct and fibre. A direct substitution of demand between TISBO and AISBO services will therefore result in a reduction in the overall usage of resources rather than a one-to-one transfer of resources from TISBO to AISBO. This means that the TISBO unit cost would not remain the same but increase as demand for TISBO services was falling. Ofcom's method effectively imposes the higher cost/inefficiency of TISBO services on AISBO services.
- 5.12 The results of two of these two effects (sharing more widely, lower AISBO usage of certain resources) can be seen in the time series analysis of the 'land and building'

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<sup>56</sup> LLCC consultation, §A5.129.

costs recovered from leased line services<sup>57</sup>, with the reduction in the proportion of costs recovered from TISBO as demand has declined not being directly matched by an offsetting increase in recovery from AISBO.

- 5.13 In addition to the 'computational' points we have highlighted above, we consider that are strong economic efficiency reasons to have a relatively higher common cost recovery from TISBO services than from AISBO services (which could be achieved by a lower reallocation). In particular:
- 5.13.1 Increasing the cost and so prices of Ethernet services will reduce the rate of migration from TISBO services and thus delay the productive efficiency gains possible by retiring the legacy TISBO equipment. As Ofcom recognises at several points it is efficient to allow legacy product prices to rise and new products to fall to encourage migration to more efficient technologies;
  - 5.13.2 The role of pricing is in part to send correct make-versus-buy signals to potential entrants which is best achieved by pricing at marginal costs. Since entry is highly unlikely in TISBO products the focus for correct signals is on Ethernet which would suggest recovery of less common cost from Ethernet services (since this will result in prices closer to marginal costs).
  - 5.13.3 To the degree that demand for innovative end user applications dependent on Ethernet services may be more elastic than the remaining users of legacy TISBO services, increasing the common costs recovered from Ethernet services may reduce overall demand (i.e. Ramsey pricing) . The remaining demand on TISBO is likely to be relatively inelastic since the remaining customers are those who value the TISBO product capabilities highly.
  - 5.13.4 By increasing the cost of Ethernet services which are used in conjunction with LLU to provide downstream services to end users, potential benefits brought by vigorous competition based on deeper infrastructure competition may be foregone; and
- 5.14 In view of the above, TalkTalk believes Ofcom's reallocation methodology is the wrong approach and not simply one of many possible or reasonable approaches. Ofcom has approached this issue in a too simplistic manner without considering all the evidence and relevant efficiency considerations. It seems to us that Ofcom has sought to simply roll over its approach from 2009. This is clearly not acceptable particularly given the points raised above and the materiality of the issue.
- 5.15 The Frontier report outlines an alternative (and, in our view, the right) methodology for allocating these fixed and common costs in a scenario of falling demand for TI and increasing demand for Ethernet services. It relies on the methodology deployed by Ofcom for setting the LLU/WLR charges which means that total forecast costs would be allocated across the relevant services using a combination of usage factors and forecast demand. The usage factors could be based on those used in BT's FAC system underlying the RFS in order to ensure consistency. Such an approach should more accurately proxy forecasts of FAC services costs by taking account of both:

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<sup>57</sup> Frontier report, page 11.

- 5.15.1 the relative movements in the volumes of all services when allocating common costs rather than the absolute changes for one service; and
  - 5.15.2 the relative usage of the underlying shared resources through usage factors.
- 5.16 We believe this would result in a more efficient outcome in that it seeks to ensure that there is no over-estimate of common cost recovery on AI as demand for TI services fall (and demand for Ethernet services increase). We believe Ofcom should adopt this approach instead of the proposed incorrect methodology in the consultation document.

### 5.2.2 RAV adjustment

- 5.17 Ofcom proposes to apply a Regulatory Asset Value (RAV) adjustment both for pre-97 and post-97 access duct to the Ethernet service basket. We support the need for this adjustment since AI services use duct a proportion of which was installed prior to 1997.
- 5.18 As a matter of regulatory policy-making, we find the complete change in approach compared to the one adopted in LLCC 2009 puzzling and unexplained. In essence, Ofcom justifies the new approach by the fact that the charge control will not apply in the WECLA area and that the new approach would not have any impact on alternative fibre investment outside the WECLA area.<sup>58</sup> These are hardly new circumstances (e.g. WECLA is simply a geographical expansion of CELA in LLCC 2009) and thus we cannot understand how they justify a dramatic change policy over the RAV adjustment. We would be grateful if Ofcom would be able to provide more detailed information as to the reason for the change of policy.
- 5.19 Although we have addressed this point elsewhere we would note that Ofcom declined to make a RAV adjustment in the provisional determinations in the ongoing Ethernet disputes (in March 2012). Needless to say, it is essential that Ofcom is consistent in its approach across market reviews and dispute resolution which means Ofcom will need to alter its approach in relation to the Ethernet disputes.

### 5.2.3 Operating cost efficiencies

- 5.20 Efficiency generally means that an operator is able to produce more output with the same resource or the same output with less resource. There are many ways in which an operator can become more efficient including areas such as: more productive labour; more efficient salary levels or structures; fault reductions; more modern technology; less labour-intensive processes; and, company restructuring.
- 5.21 Ofcom is seeking to benchmark Openreach's efficiency using alternative methodologies, e.g. comparisons against other operators, Openreach internal studies etc. It is important that the starting point for such an assessment is that the comparison must be made against what is considered efficient (e.g. efficient

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<sup>58</sup> LLCC consultation document, paragraph 6.134ff.

operators in competitive markets) as opposed to what Openreach may consider what efficiency improvements it can make operating in a near-monopolistic position or what 'best monopoly telcos' achieve..

- 5.22 Ofcom has based its efficiency analysis for Ethernet services on the following evidence:
- 5.22.1 Ethernet-specific historical trend analysis (based on BT information);
  - 5.22.2 Openreach internal efficiency targets (although not disclosed in the consultation document);
  - 5.22.3 2012 Deloitte Study;
  - 5.22.4 Statistical analysis (NERA, Deloitte); and
  - 5.22.5 KPMG Study.
- 5.23 Ofcom proposes an efficiency rate for the provision of Ethernet services of between 2% and 5% per annum. Ofcom believes this is consistent with the WLR LLU CC on the basis that the focus is on operating cost efficiency savings. We note that the efficiency range is below Openreach's internal efficiency targets (although the internal targets are not explicit in the consultation document).
- 5.24 As a general comment we note that in the past Ofcom has consistently underestimated the level of efficiency that BT achieved. For example:
- 5.24.1 when Ofcom set the current charge control for AISBO services in 2009, Ofcom concluded that the appropriate assumption in respect of the efficiency gains for services in the AI Basket was 2.8% per annum. Actually, we now know that Openreach was able to achieve between 2.7% and 4.6% during the period up to 2010/11
  - 5.24.2 In the LLU Charge Control in 2009 Ofcom projected an average efficiency gain of 2.5%<sup>59</sup> yet the actual outturn was about 6%<sup>60</sup>
  - 5.24.3 In fact, BT has achieved a higher level of efficiency than Ofcom projected in every LLU, WLR and leased line charge control over the last six years.
- 5.25 This suggests that Ofcom is (for whatever reason) systematically under-calling what is achievable with the consequence that prices are perpetually excessive. Ofcom must resist any temptation to be 'soft' on BT (yet again). There is no reason to do so in order to give BT cost minimisation incentives (see §5.38ff below) and the only effect of under-calling the efficiency gain it is to allow BT (and its shareholders) to enjoy excessive profits.
- 5.26 We comment below on each of the type of evidence relied upon by Ofcom in setting the efficiency rate.

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<sup>59</sup> included 2% reduction in faults (which equated to 0.7% reduction in all opex) and a 'tapered' efficiency assumption which equated to 1.8% on average across all opex

<sup>60</sup> See TalkTalk LLU/WLR CC Response July 2011 §269

### 5.2.3.1 Ethernet-specific historical trend analysis

5.27 We note that Ofcom proposes to place most weight on the historical evidence of efficiency gains made by Openreach which has been between 2.7% and 4.6%.<sup>61</sup> We agree that historical performance is a reasonably reliable indicator of potential future efficiency gains. We note that the Competition Commission said in the 2010 LLU Appeal by TalkTalk:

*“In general terms we think that the predictive power of historic rates of efficiency saving diminishes over time as circumstances, including cost structures and technology trends, change. In our view, however, the historical indicators of Openreach efficiency should be reliable for at least the first year of the price control, and represent useful indicators for the whole period under review.”<sup>62</sup>*

5.28 BT has frequently argued that historic trends are not relevant. It is worth noting that the Competition Commission in the previous LLU appeal rejected such BT claims:

*We also noted Mr Shurmer’s argument that specific savings Openreach had made in the past were unsustainable. In our view, Mr Shurmer’s arguments explained why specific savings made in the past might not be repeated but did not explain why historic rates of savings were an unreliable guide to savings that may be made in the future.<sup>63</sup>*

5.29 Furthermore, looking ahead now, it is clear that BT continues to find significant operational cost efficiency gains and believes that it will do so into the future. Its 2012 annual report confirms this:

*“Overall, we made good progress with our cost transformation activities during 2012. We reduced operating costs by £933m or 6%, with savings across all our main cost categories. This represents a cumulative reduction in operating costs of £2.9bn over the last three years.”<sup>64</sup>*

*However, through continued forensic analysis of our cost base, we still see plenty of opportunities in the coming years. Cost transformation is about improving efficiency and reducing the cost of failure.<sup>65</sup>*

*We expect to make further progress in transforming our cost base which will drive growth in adjusted EBITDA in 2013 and 2014.<sup>66</sup>*

*We have been taking a phased approach to cost transformation. The first phase focuses on the efficiency of our expenditure in areas such as labour costs, consultancy spend and procurement from third parties. The second phase tackles ‘right first time’ process re-engineering and the reduction of overhead costs. The third phase looks at in-sourcing and output-based pricing. All these phases continue across the business with a particular focus on end-to-end process re-engineering to improve service and reduce costs still further.<sup>67</sup>*

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<sup>61</sup> §A5.100

<sup>62</sup> LLU Determination §2.185

<sup>63</sup> LLU Determination §2.183

<sup>64</sup> BT 2012 Annual Report, page 23.

[http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/BTAnnualReport2012\\_smart.pdf](http://www.btplc.com/Sharesandperformance/Annualreportandreview/pdf/BTAnnualReport2012_smart.pdf)

<sup>65</sup> BT 2012 Annual Report, page 40.

<sup>66</sup> BT 2012 Annual Report, page 40.

<sup>67</sup> BT 2012 Annual Report, page 23.

*By being more efficient in customer service delivery and transforming our cost base we can provide services on a more competitive basis and improve our cash generation, which in turn means we can invest in the future of the business and drive growth.*<sup>68</sup>

*Our future plans include ... reducing our cost base significantly, while increasing the skills and productivity of our people.*<sup>69</sup>

5.30 We agree with Ofcom's approach of placing most weight on the historical efficiency evidence (when compared with other efficiency evidence presented in the consultation document).

5.31 In terms of the appropriate benchmark level of historic efficiency savings, we note that Ofcom concluded in the 2012 WLR LLU CC that the appropriate forecast was 5% which was at the top of the historic range (4% to 5%):

*"In summary, Openreach's historical efficiency rates (2007/8 to 2009/10) have outturned at around 4%. We estimate the most recent outturn (2010/11) to be higher at 5% (following adjustments). Linear extrapolation of our outturn estimates result in a forecast for 2011/12 of 5%. We have chosen not to extrapolate the data beyond one year due to the limited number of observations (four data points) on which the projection is based. We conclude that the historical data implies an efficiency target range of between 4% and 5% (gross)."*<sup>70</sup>

5.32 The above efficiency figures appear to be slightly at odds those quoted in the LLCC consultation document that refer to past annual efficiency savings ranging between 2.7% and 4.6%<sup>71</sup> although Ofcom claims the two sets of data are similar.<sup>72</sup> It appears inconsistent that Ofcom is using a range (2% to 5%) that is below the historic level.<sup>73</sup>

### 5.2.3.2 Openreach internal efficiency targets

5.33 Ofcom does not disclose any of the Openreach internal efficiency targets so it is impossible to comment precisely on whether they seem reasonable. We note however that Ofcom says that they are "higher" than the Ofcom 2% to 5% range [LLCC 6.165] so perhaps they are 3% to 6%.

5.34 We make two points in respect of the internal efficiency targets.

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<sup>68</sup> BT 2012 Annual Report, page 24.

<sup>69</sup> BT 2012 Annual Report, page 26.

<sup>70</sup> WLR LLU statement, March 2012, §A.326.

<sup>71</sup> LLCC consultation document, paragraph A5.89.

<sup>72</sup> LLCC consultation document, paragraph A5.87.

<sup>73</sup> We note that Ofcom considers TI products warrant a lower efficiency gains compared to other services [LLCC §§5.147, A5.58]. This begs the question where are the services where higher than average efficiency assumptions are applied. Further, we note that Ofcom argues that TI services warrant a lower efficiency gain (than copper services) since they are more mature. However, by the same token Ethernet services should have a higher efficiency gain than copper (5% gross) since they are less mature yet Ofcom proposes to apply an efficiency range of 2% to 5%.

- 5.35 First, BT are likely to under-estimate what they will likely achieve since there are clear and strong incentives for management to set low targets:
- 5.35.1 Under-estimates increases the chance that management will meet their targets and receive performance bonuses.
  - 5.35.2 There is an incentives for businesses to under-estimate performance to the City.
  - 5.35.3 There is a further incentive to set low targets since they know that the regulator will use them to some degree in setting charge controls and the lower the target, the higher the costs and prices and so the greater BT's profit.
- 5.36 Indeed in the past BT has exceeded its own internal efficiency target(s).<sup>74</sup>
- 5.37 Second, there is the question of whether to set a target below that BT thinks it can achieve in order to provide BT with cost minimisation incentives. Ofcom thinks that that Openreach's cost minimisation incentives are improved if the efficiency assumptions used to set prices is easily 'achievable'. For example:
- "We also note that, whilst [Ofcom's] target range is below the internal targets set in the MTP, we believe it is realistic and provides Openreach with an incentive to meet those internal targets and outperform the targets proposed under the charge control." [LLCC §A5.101]*
- "... we believe [the efficiency target] is realistic and provides Openreach with an incentive to meet those internal targets and outperform the targets set under the charge control." [LLCC 6.165]*
- "In this way, an RPI-X type of control provides incentives to 'outperform' the charge control" [LLCC 3.5]*
- 5.38 Ofcom's logic here is not correct. Openreach's incentive to minimise cost is solely related to how profitable a cost reduction will be (and not to do with the efficiency assumption used). For instance, the more any cost reduction has to be passed through in reduced prices the less profitable and so the weaker the cost minimisation incentive. The cost minimisation incentive does not relate to the actual price or the assumptions used (such as efficiency improvement) to calculate the price in the first place.
- 5.39 It is important that Ofcom recognises this logic since there is absolutely no need for Ofcom to set an "easy" or "achievable" level of efficiency in order for BT to have incentives to minimise cost. BT's cost minimisation incentives will be the same whether the efficiency assumption is 2%, 5% or 8%.
- 5.40 In light of the internal target, which is above Ofcom's assumption, we suspect Ofcom is being far too lenient with Openreach when setting the efficiency assumption between 2% and 5%. By way of comparison, in the WLR LLU CC, Ofcom refers to an internal efficiency average target of 4% whereas it eventually adopted an efficiency

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<sup>74</sup> See TalkTalk LLU/WLR CC Response July 2011 §286 bullet 3

figure of 5%.<sup>75</sup> The reasoning with regard to the proposed AISBO charge control appears inconsistent with this past practice. In any event, we do not believe that there is any overriding reason as to why the efficiency target used in the forecast modelling could not be set at or even above the Openreach internal target.

### 5.2.3.3 2012 Deloitte Study

- 5.41 We note that this report was commissioned by BT Wholesale to assess its efficiency relative to five other European operators. The report has not been made available to other operators so it is very difficult to comment on its relevance or otherwise. We note however that Ofcom has some concerns about the robustness of the results for a number of rather detailed reasons that we will not repeat here.<sup>76</sup> However we would make the following remarks as to the relevance for Ethernet circuits:
- 5.41.1 The obvious comment is that the report has been commissioned by BT and not Ofcom. It goes without saying that BT would never seek to rely on any report that did not support its case. For this reason alone, Ofcom should remain sceptical to the report as a valid base of empirical evidence.
- 5.41.2 The report seemingly assesses the efficiency of BT Wholesale so is of limited if any relevance when it comes to assessing the efficiency of Openreach who delivers Ethernet circuits.
- 5.41.3 The report compares the efficiency of BT against six other monopoly European operators (although it is not known which operators). It is hardly surprising that BT comes out on top. The UK market was liberalised first in Europe so BT will naturally have been subjected to competitive pressures for longer than any other operator in Europe hence it is going to be more efficient. As mentioned above it is essential that an efficiency assessment is made against efficient operators (i.e. not in monopoly situations) and we would strongly doubt any large incumbent operator in Europe would meet the criteria of being a genuinely efficient operator.
- 5.41.4 BT Wholesale is delivering legacy TISBO circuits and the scope for efficiency improvements will be much smaller compared to Openreach's delivery of new modern technology (such as Ethernet) where the room for finding further efficiency gains will be much larger. The two products cannot be compared (indeed Ofcom is proposing a much lower efficiency rate of 0-3% for TISBOs).
- 5.42 For the above reasons, we believe Ofcom should completely disregard the 2012 Deloitte Report as irrelevant when assessing the efficiency of Openreach's delivery of Ethernet circuits. We note that in the 2012 LLU/WLR CC Ofcom rejected using similar benchmarking data (in that case from Wyman) since:

*“... we believe it would be inappropriate to place much weight on these results and to use the IBR as a direct source of an efficiency benchmark (by using the “peer average” metric)*

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<sup>75</sup> WLR LLU statement, March 2012, §A.9.

<sup>76</sup> §A5.77.

*because the changes in “peer average” costs as applicable to BT appear to be inconsistent with movements within a competitive market.” [2012 LL/WLR CC §A5.31]*

#### 5.2.3.4 Statistical analysis (Nera, Deloitte)

- 5.43 We note that Ofcom has attributed little weight to these reports on the basis that they are less specific to Ethernet services. We agree and would emphasise that these reports are largely irrelevant and unreliable when assessing the efficiency in relation to Ethernet services:
- 5.43.1 It compares BT to other monopolies rather than companies in competitive markets and therefore is not indicative of efficient costs
  - 5.43.2 It compares BT Group with US LECs and BT Group and there are very significant differences in their operating environments – for example, different regulatory systems, different cost measures e.g. HCA vs CCA accounting, different product mixes, different accounting standards and geographical differences. We doubt that many of these differences will have been properly controlled for
  - 5.43.3 It provides benchmark costs for BT Group not for Openreach. Openreach has more potential to make greater efficiency savings than the rest of BT Group since it has faced less competition.
  - 5.43.4 The base NERA study is out of date since it was produced in 2008. A similar criticism can be levelled against the Deloitte report that was produced in 2010 (i.e. over two years ago).
  - 5.43.5 It is not used by BT or Openreach as a basis for their own budgets/planning suggesting that BT does not consider it that is relevant or reliable
  - 5.43.6 It has historically greatly underestimated Openreach’s potential efficiency gains. For instance:
    - 5.43.6.1 in the 2009 LLU CC Review this analysis indicated an annual efficiency gain of around 1%<sup>77</sup> yet the actual outturn was over 6%
    - 5.43.6.2 in 2006 a similar study suggested a 1.5% gain but the outturn was a 4% efficiency gain<sup>78</sup>.
- 5.44 We submit therefore that Ofcom should in fact largely ignore these studies (which indeed is what Ofcom appears to have done anyway).

#### 5.2.3.5 KPMG Study

- 5.45 In the WLR LLU CC statement, Ofcom concluded that:

*“the KPMG report provides evidence of an efficiency estimate of above 3%. This estimate is based on the KPMG estimate, increased to include efficiency savings of around 0.5% to*

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<sup>77</sup> Report estimated 0.8% and 1.8% on compressible costs including depreciation. This equates to 0.8% to 1.5% on opex and capex.

<sup>78</sup> LLU Determination §2.195.

*account for fault rate efficiencies. Since this estimate excludes some cost types such as task times, our efficiency target will accordingly be higher than this estimate.”*<sup>79</sup>

- 5.46 We agree with Ofcom’s conclusions with regard to the KPMG report. In particular we believe Openreach can still make further savings in the form of productivity improvements and task time reductions that are not counted in the KPMG study. Again we would note that Ofcom set an efficiency target of 5% in the WLR LLU CC and believe that a similar target is justified with regard to AISBO. This market is still developing rapidly and will continue to do so over the three-year charge control period. There will be plenty of opportunity for Openreach to find efficiency improvements as part of this development.

### 5.2.3.6 General Openreach inefficiency

- 5.47 We believe there is plenty of evidence (anecdotal and otherwise) of inefficiencies within Openreach which means there is substantial scope for further efficiency improvements<sup>80</sup>:
- 5.47.1 BT operates a ‘non-compulsory redundancy’ scheme which essentially offers employees a possibility to stay on BT’s payroll by opting to move into a career transitioning centre or into another role in BT rather than being made redundant. This forces BT to maintain staff on high salary levels rather than recruiting new staff on a competitive and open labour market and makes it difficult to lose poorly performing staff.
  - 5.47.2 BT has a very low staff churn rate (of around 3% per year) which is indicative of excessive pay levels. It also means that there is little market pressure on pay rates
  - 5.47.3 We understand BT’s engineering force suffers from low productivity compared to other operators of its size mainly due to union resistance to change in working patterns and practices.
  - 5.47.4 There is strong empirical evidence that Openreach’s pay levels are excessive. For example, Openreach’s time-related charges suggests an average cost of £75 per hour worked which compares to TalkTalk’s Bright Sparks cost (for similarly qualified engineers) which is £23 per worked hour<sup>81</sup>. Overall, recent pay settlements between BT and its unions suggest that BT is paying above average pay increases (9% over three year period to 2012 compared to industry average of about 4%). In the current financial year (2012/13) TalkTalk has implemented a pay increase of only 1-2% across the company.
  - 5.47.5 BT operates a comparatively generous and hence costly pension scheme with above industry company contribution rates. Also BT unusually operates a

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<sup>79</sup> WLR LLU statement, March 2012, §A3.54.

<sup>80</sup> For further expansion on these points see TalkTalk’s submission on the LLU/WLR Charge Control in July 2011 §§290-308. The submission can be found at:

<http://stakeholders.ofcom.org.uk/binaries/consultations/wlr-cc-2011/responses/ttg.pdf>

<sup>81</sup> See TalkTalk LLU/WLR CC Response July 2011 §299

defined benefits pension scheme that is open to new contributions from existing members.

5.47.6 BT has a comparatively high level of corporate overhead.

5.48 In summary, Openreach is lumbered with an out-of-date organisational design with inefficient working and employment practices which leads to inflated pay levels and poor employee performance management. Although only individual examples, they suggest that Openreach's costs are inefficiently high in many different areas which offer potentially significant scope for improvement.

#### 5.2.3.7 Conclusions on cost efficiencies

5.49 We believe that Ofcom's efficiency rate range of 2% to 5 % is a reasonable starting range but that the relevant evidence supports the application of an efficiency rate in the forecast calculation at the very top-end of that range (rather than using the mid-range value of 3.5% as suggested by Ofcom in the consultation document). We submit that Ofcom should use an efficiency rate of 5% based on the following considerations since:

5.49.1 Historical and projected efficiency savings show that this is a realistic target (e.g. as shown above Openreach was able to achieve efficiency savings of up to 4.6% in 2010/11 and BT's annual report for 2011/12 shows efficiency savings of up to 6%).

5.49.2 Although not disclosed in the consultation document, Openreach's internal efficiency projections are above Ofcom's 2% to 5% range and it is likely that Ofcom internal estimates will under-estimate what can be realistically achieved

5.49.3 There is plenty of other evidence suggesting Openreach is operating in an inefficient manner which offers scope for further efficiency improvements.

5.49.4 The other potential efficiency evidence discussed in the consultation document should, as Ofcom suggests, be given less weight or disregarded altogether.

5.49.5 There is absolutely no need or justification to set a low efficiency target in order to provide BT the incentives for cost minimisation. BT incentives to minimise cost are not affected by the efficiency assumption made

#### 5.2.4 Capital cost efficiencies

5.50 Ofcom has assumed no efficiency gain on capital expenditure (between 11/12 and 15/16) since, it claims, Ofcom's use of the MEA approach takes efficiency improvements into account:

*Aspects relating to efficiencies in capex are already taken into account through our use of the MEA approach ... [LLCC 6.158]*

5.51 We disagree with Ofcom, the MEA approach reflects the costs of MEA technology today (2011/12) based on today's productivity levels. There will be efficiency improvements in the future – for instance:

5.51.1 labour costs for the MEA technology (which are capitalised) will be reduced through newer and quicker techniques for the installation of equipment; more flexible working practices; using less skilled/lower cost staff; and/or reductions in overhead and management

5.51.2 there are some capital costs (such as duct and fibre) which are not affected by the MEA assumption. These can be expected to experience efficiency gains and indeed in the past Ofcom has assumed efficiency gains.

5.51.3 These efficiency improvements are not accounted for by the reduction in units prices (see LLCC Table A5.13)

## 5.2.5 Cost of capital

5.52 Ofcom proposes to use the cost of capital figure relating to 'rest of BT' (6.5% pre-tax real WACC) as calculated in the WBA market review. We believe using the 'rest of BT' figure overstates the business risk and WACC for supplying Ethernet circuits.

5.53 The rest of BT WACC effectively reflects the WACC for the non-copper access parts of BT Group i.e.

5.53.1 regulated wholesale leased lines (TI and Ethernet)

5.53.2 wholesale broadband access, wholesale voice services

5.53.3 UK residential / business retail services

5.53.4 telecoms/IT services to large corporates in UK and overseas.

5.54 We think that these other areas have materially higher levels of risk / volatility than the supply of wholesale Ethernet/TI. In particular:

5.54.1 There is more volatility in overall market demand in these other areas in particular in IT services market. The fixed/mobile backhaul market is particularly low risk since the volume is predictable and to a large degree insulated from economic cyclicity and demand volatility in the retail market

5.54.2 These other services are largely exposed to far higher competitive risk (and so market share risk). In few of these other areas does BT have SMP. In contrast, BT's share in many of the regulated leased line markets is highly stable e.g. AISBO market share has only declined from 69% to 67% in the last 4 years [BCMR table 64].

5.54.3 Prices for Ethernet services are far more predictable than for the other services since they are (for the most part) regulated. In contrast, prices for the other services are typically subject to competitive and market forces

5.54.4 There is a larger degree of risk of stranded assets in these other areas. In the case of Ethernet products Ofcom's allowance of migration credits effectively

protects BT from the risk of stranded assets. Such protection is not afforded in competitive markets

- 5.55 Although we accept that the copper access cost of capital figure may not be entirely appropriate to use for Ethernet services (given that it relates to the copper access network) we believe a lower figure should be used than the rest of BT figure. Given there are limited reference figures for the cost of capital, we consider that Ofcom should at the very least use the BT Group figure of 6.1% to acknowledge the relatively lesser risk versus the 'rest of BT'.
- 5.56 We note that Ofcom intends to update the WACC figure with the new, lower corporation tax of 22% in its final statement. We agree with this approach to ensure that the WACC is as up-to-date as is reasonably possible (noting that the current WACC figures in the consultation document are becoming more outdated anyway).

#### 5.2.6 Excess Construction Charges (ECC)

- 5.57 We note regarding excess construction charges (ECCs) that previously this cost was double recovered (firstly in connection charges and also in rental charges since the costs were capitalised and form part of the 'cost-stack' for rental services) [see LLCC 7.11]. The over-recovery has been about £10m per year<sup>82</sup> and probably has totalled more than £100m (in present value terms). We obviously agree with Ofcom that this double recovery should be corrected in this charge control by excluding these assets from the asset base in 2015/16.
- 5.58 However, even if this is done and so the price in 2015/16 is reasonable, BT will still benefit from the error through excessive rental prices in 2013/14 and 2014/15 (due to the way the glidepath operates). Therefore, Ofcom should consider making a starting adjustment to rental prices to prevent BT from continuing to benefit from this error.
- 5.59 There also is a separate question of whether and how the historic over-recovery should be remedied. This error is unlike say an 'outturn error' (i.e. difference between forecast and outturn) in the volume, efficiency or cost of capital forecast where a (hopefully unbiased) estimate is made (and there is risk on both sides). In that case, retrospection would be unjustified. In contrast, this was an error (possibly that BT was well aware of) that has unequivocally led to an overcharge. We think Ofcom should consider whether there should be repayment of the overcharge (by means of, say, reducing the allowed cost base in 2015/16).
- 5.60 It would also be useful if Ofcom could explain how such a basic error was made in the RFS and previous charge controls. After all the RFS were audited and Ofcom has the ability to scrutinise them.

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<sup>82</sup> The mean capital employed was £64m (see LLCC 7.14). The return on capital employed would therefore be about £7m (using 11% WACC from 2009 leased line charge control). Including depreciation the total capital charge is likely to have been about £10m.

5.61 Regarding ECCs it is not clear whether ECCs are allocated any common cost. We consider that they should be and that (if it has not been done) the FAC allocation to other services should be reduced.

### 5.2.7 Trade creditors

5.62 We are not sure whether trade creditors are included in the calculation of costs (and particularly the mean capital employed). Trade debtors are included. We see no reason to exclude trade creditors. At a BT Group level, trade creditors exceed trade debtors<sup>83</sup> which would suggest that they will have a material effect.

## 5.3 Other charge control aspects

5.63 Below we comment on three aspects of the design of the charge control: the treatment of geographic discounts; the use of prior or current year weighting; and starting year adjustments.

### 5.3.1 Geographic discounts offered by Openreach

5.64 We note Ofcom's proposal not to allow geographic discounts offered by Openreach to contribute towards meeting the charge control obligations (i.e. required average reduction in average prices) but that existing discounts will be taken into account in the base year which reduces the value of X.<sup>84</sup>

5.65 We fully support the first proposal but have some concerns regarding the second proposal. It does not appear to us that Ofcom has fully considered the potential implications of allowing existing discounts to be taken into account in the base year.

5.66 The effect of allowing existing discounts to be taken into account in the base year revenue is that:

5.66.1 If BT reduces average headline (i.e. excluding geographic discounts) prices by RPI-12% and maintains the same discounts as now then its revenues in 2015/16 will equal the estimated costs (i.e. it will achieve its allowed cost of capital)

5.66.2 If however BT reduces average headline prices by RPI-12% and increases the level of discounts its revenues will be less than 2015/16 costs (all else equal<sup>85</sup>)

5.66.3 Alternatively, if BT reduces average headline prices by RPI-12% and reduced the discounts from the current level (and volumes remain the same) then it could achieve more revenues than 2015/16 costs and its profit will be excessive.

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<sup>83</sup> See 2012 BT Annual Report in which page 124 shows trade receivables of £1,747m and trade payables of £3,261m.

<sup>84</sup> LLCC consultation, §4.145.

<sup>85</sup> Assuming no volume changes.

- 5.67 Thus it seems to us that by using Ofcom's construct (of including existing discounts in the current revenue) BT might be able to 'game' the system to achieve higher revenues than was intended by removing/reducing the discounts (as in the third example above).
- 5.68 Ofcom does not appear to have considered whether there is any reasonable underlying cost-justification for offering these geographic discounts and to what specific services they apply. For instance, if Openreach had chosen to offer discounts for EAD services but not EBD services, the fact that they were taken into account would mean that the price of EBD services would be reduced by a lesser amount than if the discount had not been taken into account (because the same charge control of RPI-12% applies to both services). If BT offered discounts on EAD services but not EBD services suggests that the competitive conditions in these market segments are not the same.
- 5.69 There is a separate concern that BT may have a distorted incentive to introduce further discounts in this charge control period in the expectation that they would be taken into account by Ofcom at the start of the next charge control period. BT would then in effect be able to recover some of the costs associated with targeted geographic discounts during future charge controls.
- 5.70 In view of the above, we believe Ofcom needs to review its proposal to allow existing geographic discounts to be taken into account to ensure there is no competitive distortion and no scope for gaming by Openreach of this and/or future charge controls.

### 5.3.2 Current or prior year weighting

- 5.71 We read with some puzzlement Ofcom's assessment of current year weighting (CYW) and prior year weighting (PYW) to assess compliance of price changes. Ofcom has proposed to (continue to) use PYW – that Ofcom is continuing with its approach it has previously taken is not surprising though disappointing. What was rather astonishing though was how partial and biased Ofcom reasoning was – Ofcom failed to even mention the key weakness of PYW and many of the advantages that it attributes to PYW are illusory. For example:
- 5.71.1 The main weakness of PYW is the ability of BT to 'game' the charge control and achieve a higher average price increase than the RPI-X cap intended by focussing price decreases on products declining in volume. Yet Ofcom fails to mention this at all. The CC<sup>86</sup> has plainly recognised this disadvantage. We note that the risk of gaming is increased where there is a broad basket (as for Ethernet services) where growth rate vary significantly

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<sup>86</sup> The Carphone Warehouse Group plc v Office of Communications Case 1111/3/3/09 LLU Determination §3.178. "We consider that Ofcom erred by failing to provide sufficient safeguards to prevent Openreach from manipulating prices to its commercial advantage in one respect, as claimed by CPW; namely, that Ofcom failed to provide safeguards to prevent Openreach from achieving higher average price increases by increasing prices by more on growing volume products within the co-mingling basket."

- 5.71.2 Ofcom claims that CYW suffers from the ‘apples and pears’ problem since “average revenue can be affected by a change in the product mix within the basket” [4.113]. Yet PYW suffers from the exact same problem that average revenue is affected by mix
- 5.71.3 Ofcom claims that PYW is more transparent for stakeholders [LLCC 4.114]. That is plainly false since stakeholders do not see or know what weightings are used (whether they are prior year or current year)
- 5.71.4 Ofcom claims that under a PYW Openreach will know the weightings with certainty. This is misleading since the prior year weights will not be known until after the end of the prior year yet the price changes at the start of a year will need to typically be announced 90 days before the start of the year and will probably rely on weighting data 4-5 months before the start of the year
- 5.72 It seems to us that Ofcom’s genuine reason for preferring PYW over CYW is that (a) it is a continuation of what it has done before (and Ofcom prefers consistency) and (b) that it is administratively simpler (since less ‘truing up’ is likely to be required). If that is Ofcom’s case, Ofcom should be straightforward and plainly state it.
- 5.73 In respect of the issue of weightings and compliance we consider that BT’s RFS should include a compliance statement that shows the average price change and weightings for the elements in the basket (the average price change should be shown using the previous year weights and the current years weights).

### 5.3.3 Starting year adjustments

- 5.74 We generally agree with Ofcom’s approach of not applying start year adjustments. However, we consider that Ofcom’s approach of when to apply them as rather erratic and unfounded.
- 5.75 The first point is that Ofcom says it “typically compare[s] the charges to cost orientation benchmarks (i.e. DRLIC and DSAC), as this would provide an indication of whether charges are likely to give rise to distortions in competition.” [LLCC 5.128]. This is nonsense – DLRIC and DSAC costs/prices are not indicative of competitive distortions. They have little or no economic relevance. They are in essence arbitrary cost figures that lie between (in the case of DSAC) LRIC+EPMU costs and SAC costs. They have no logical link to competitive effects. For Ethernet services, DSACs are typically two to three times FAC<sup>87</sup> and prices at twice FAC can easily give rise to detrimental effects. Thus Ofcom is wrong to use these DSAC/DLRIC benchmarks to test whether starting price adjustments are required.
- 5.76 Second, Ofcom does not even seem to apply this approach consistently. It has made adjustments to ECC even though they are within these benchmarks (we agree with these adjustments). Ofcom should be clear about its approach and policy.

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<sup>87</sup> See BT RFS 2012 pages 51 and 52

- 5.77 Third, we consider that there are other reasons as to why starting price adjustments would be warranted – for instance, where there was a cost over-estimation error in the previous charge control (and so price prior to this charge control) that BT could have spotted but did not. An example of this is the double-recovery of ECC asset costs – see section 5.2.6 above.
- 5.78 Fourth, Ofcom highlights that it might not make (downward) starting price adjustments where BT makes voluntary reductions since this might be more proportionate [LLCC 4.104]. We are not quite sure what Ofcom means by being ‘proportionate’ however it seems that Ofcom is suggesting that it prefers a non-formal approach to formal regulation (though for reasons unspecified). We cannot see a valid reason for this unless it can be shown that the voluntary approach delivers the same reduction as would have been imposed by Ofcom using formal regulation. We do not think it appropriate for Ofcom to compromise and have its powers eroded by accepting lower voluntary price reductions than were justifiable.

## 6 Interim pricing

- 6.1 Though the current charge control will lapse on 30 September 2012, the new charge control will not be ready to be implemented until Q1 2013 meaning that no charge control will be effective for an interim period of around 6 months i.e. October 2012 to March 2013.
- 6.2 Openreach and BT Wholesale have made a number of price changes which will be effective from 1 October 2012. They have committed to not to make further price changes (under certain conditions). In the AISBO area these price changes are a mix of price increases (e.g. WES/WEES 10, 100, 155 rentals and main link), price decreases (WES/WEES 622, 1000 and EAD 1000 rentals) and no price changes (EADLA, EAD 10, 100, EBD 1G). We do not know what the net effect of this is though Ofcom says that the prices changes have 'limited impact' [LLCC 10.59] – which we assume to be shorthand for zero net change. This compares to an estimated RPI-12% reduction (i.e. about 9%) reduction in prices that would have been effective had the charge control been in place. Assuming a six month interim period BT's external AISBO revenues will be about £13m<sup>88</sup> higher than would have been allowed under the charge control.
- 6.3 We cannot understand why Ofcom has been so lax on BT and allow it to recover £13m more that it would be allowed to if the charge control was in place. Why did Ofcom not informally request BT to make price reductions similar to those estimated under the charge control? Ofcom's approach follows on from a similar lax approach on LLU where it allowed BT to price MPF at £91.50 through FY 2011/12 even though in March/May 2011 Ofcom estimated the correct price at £90 (mid case) and that the final price came out at £87.41. This resulted in BT over-recovering by about £15m
- 6.4 Ofcom has not explained why or justified why it has taken such a lax approach. To our mind there is no reason to allow BT to (again) price excessively in this way.

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<sup>88</sup> External AISBO revenues in 2011/12 were £280m (see RFS p51). Assuming that the delay is 6 months when there should have been a 9% reduction but there was no reduction means that BT's revenue is about £24m higher (= £280 x 9% x 6 / 12 ) than it should have been.