



**OFCOM CALL FOR INPUTS
FIXED ACCESS MARKET REVIEWS: WHOLESALE LOCAL ACCESS, WHOLESALE FIXED ANALOGUE
EXCHANGE LINES, ISDN2 AND ISDN30; AND
WHOLESALE BROADBAND ACCESS MARKET REVIEW**

RESPONSE BY BRITISH SKY BROADCASTING GROUP

1. This is the second response by British Sky Broadcasting Group (“Sky”) to Ofcom’s calls for inputs in relation to its reviews of the fixed access markets and the wholesale broadband access (“WBA”) markets¹. In this response, Sky outlines its views on the relevant considerations when applying charge controls and/or cost orientation remedies.
2. The appropriate **costing methodology**² in the fixed access markets is one that:
 - a) is based upon the costs of BT’s actual copper network as opposed to a fibre-based modern equivalent asset (“MEA”) approach or the anchor pricing approach favoured by Ofcom. Both direct and indirect costs related to fibre should be excluded from the relevant LLU and WLR cost stacks and base year calculations;
 - b) minimises the uncertainty caused by volatility in copper input prices; and
 - c) apportions common costs equally between MPF and WLR unless there is a strong case to adopt a different approach.
3. In terms of **cost modelling**³ for the LLU and WLR charge controls, Ofcom’s proposed move away from its current approach to one that projects forwards the costs of the charge controlled services on the basis of asset and cost volume elasticities (“AVEs”/ “CVEs”) is likely to be simpler but has some weaknesses that should be addressed. In particular, it would result in:
 - a) less transparency which reduces the efficacy of the consultation phase;

¹ Ofcom *Fixed access market reviews: wholesale local access, wholesale fixed analogue exchange lines, ISDN2 and ISDN30 - Call for Inputs* 9 November 2012; Ofcom *Review of wholesale broadband access markets - Call for Inputs* 9 November 2012.

² Outlined further in *Fixed Access markets: Call for Inputs - Ofcom’s proposals for the cost standard to be used for LLU and WLR charge controls*, January 2013, Frontier Economics (a report jointly commissioned by Sky and Talk Talk).

³ Outlined further in *Fixed Access markets: Call for Inputs - Ofcom’s proposals for the cost modelling to be used for LLU and WLR charge controls*, January 2013, Frontier Economics (a report jointly commissioned by Sky and Talk Talk).

- b) less effectiveness in forecasting CAPEX; and
 - c) increased scope for common cost misallocation.
4. There are some **discrete issues** where Ofcom's current approach could be improved by:
- a) adopting a more structured, transparent method for forecasting **line volumes** and **copper scrap income**;
 - b) investigating further the **line length differential** between MPF and WLR; and
 - c) no longer considering that adopting a target **efficiency rate** for a charge control from the bottom of its proposed efficiency range is required in order to maintain incentives on BT to beat it. This incentive would be equally strong were Ofcom to select a rate from anywhere else in the range.
5. In relation to the appropriate BT **cost of capital** to apply to the charge controls:
- a) while it may remain appropriate to estimate the Risk Free Rate ("RFR") by aiming above Index Linked Gilts ("ILGs") data, this could be done by cross-referencing to reliable estimates of the sustainable growth rate in Gross Domestic Product ("GDP") - with which there should be a strong correlation to the RFR;
 - b) should Ofcom continue to associate periods of a high BT debt premium solely with higher default risk as opposed to higher debt beta, then it could aim lower in the debt premium range estimates; and
 - c) when disaggregating BT's Weighted Average Cost of Capital ("WACC") in order to arrive at a WACC for Openreach's copper access business, Ofcom should consider whether BT's non-price regulated activities (such as its fibre deployment and investment in content) mean that there is now a greater gap between the riskiness of the Openreach copper access business and the rest of BT.
6. Where there is a likelihood that one charge control will expire before the next one starts or where the sub-caps, sub-baskets and inertia clauses are insufficient to prevent excessive pricing, it would be proportionate to maintain a **cost orientation** remedy.
7. While a fibre-based MEA approach is unsuitable for the LLU and WLR charge controls, Sky supports a MEA approach for any **WBA charge control** in Market 1 but, crucially, and in a similar vein to Ofcom's proposed method for setting the next Network Charge Control ("NCC"), one which is based on ADSL2+, MSANs and Ethernet backhaul. This differs to the anchor pricing approach taken in the current WBA charge control where Ofcom's adopts a hypothetical ongoing model of BT's legacy technology deployment.

COSTING METHODOLOGY

Neither a MEA nor an anchor pricing approach to cost modelling is justified

8. Sky agrees with Ofcom that, when setting charge controls for fixed access services (i.e. LLU and WLR), it is inappropriate to use a MEA approach based on next generation access

("NGA"). This is, in part, because it is too difficult to predict with any reasonable level of precision the abatement that would need to be made to forecast fibre access costs in order to account for the lower level of functionality offered by LLU and WLR.

9. While there has been little willingness amongst consumers to pay much more to receive fibre-based services to date, this may change over time as new services develop to exploit the faster speeds of fibre. However, there is no certainty as to the scale, scope and timing of this change in demand side conditions.
10. Moreover, as BT's access infrastructure is largely non-contestable, non-replicable and involves significant sunk costs, any benefits that may accrue from modelling costs for the charge controls on those of a hypothetical new entrant in order to encourage only efficient alternative infrastructure investment are unlikely to be significant.
11. Therefore, Sky considers that the appropriate approach in this instance is one that is founded upon BT's costs of providing LLU and WLR. Under this approach, fibre-related costs - both direct and indirect - would be excluded from the costs stacks for WLR and LLU and fibre-based services would make an appropriate contribution to common costs⁴.
12. This approach differs to the proposed anchor pricing approach put forward by Ofcom whereby all access services are assumed to be copper-based (irrespective of whether some are actually fibre-based). In Sky's view, Ofcom's hypothetical access network model would not offer any real benefits over the approach described above but, adversely, would entail increased risks of over-/under-recovery and could not be easily reconciled to BT's actual deployment costs.
13. It is right to eschew the modelling of a fibre-based MEA because it is too impractical and because the objective of setting prices on the basis of true replacement costs can be deprioritised in the case of fixed access. Equally, it would not be appropriate for Ofcom to set prices instead by reference to a hypothetical model of the replacement costs of an ongoing copper access network - which is clearly not the MEA nor does it reflect BT's actual access network.

Under Ofcom's current approach to valuing BT's copper cable, copper price volatility can introduce an unnecessary level of uncertainty

14. Ofcom's current approach to valuing copper involves taking the price that BT is currently paying for copper cable and then forecasting how it will change over the course of the charge control period. In recent years, however, the price that BT pays for copper has been far more volatile and unpredictable than any other major cost input into access charges which, in turn, has introduced greater uncertainty for BT's customers as to the future level of wholesale access prices. Only once Ofcom formally sets the charge control is this uncertainty removed and only for the period of the control itself.
15. In light of the increased uncertainty caused by copper input prices compared to other major cost inputs, we consider it appropriate for Ofcom to assess the case for adopting an alternative, methodology that avoids this weakness.

⁴ With respect to FTTP networks, it may be appropriate to pool any resultant new build duct costs into overall duct costs before sharing these costs with all access services.

Recovering common costs equally between MPF and WLR

16. Equal common cost recovery between access services is a reasonable starting point but should not preclude a different apportionment method should it be properly justified. A key assumption, therefore, is that the common costs being recovered are truly 'common' and are not directly or indirectly attributable to one access service more than another.
17. Furthermore, under Sky's preferred approach of basing costs on BT's actual network (and not Ofcom's hypothetical operator model), certain common costs would be apportioned to fibre-based services as well.

COST MODELLING

18. The current approach to cost modelling for the LLU and WLR charge control is relatively complicated but it offers a greater degree of transparency than is available from BT's Regulatory Financial Statements ("RFS") which, in turn, has enabled stakeholders to contribute more effectively to the consultation process. This, in our view, has improved the credibility of some of the key assumptions that underpin the current charge controls and, where it has not, the basis for disagreement between stakeholders and Ofcom has become evident.
19. Ofcom proposes to move away from the current approach to one that aims to simplify the cost forecasting and cost allocation processes for WLR and LLU. While a simpler methodology has some benefits, it is important to maintain the current level of transparency of how costs are allocated between services in order to ensure that stakeholders are able to contribute to Ofcom's analysis effectively. Given the extensive knowledge of relevant issues held by other telecoms operators, this is a key driver of better decision making.
20. In addition, there are some areas where an AVE/CVE approach (whereby cost and asset changes are linked to volume changes) could be a less accurate method by which to forecast costs than the current method. Specifically, capital expenditure related to the access network is unlikely to correlate neatly with access line volumes. This is because investment in the access network is long term with very high fixed and sunk costs. Volume changes during the course of a three-year charge control period are unlikely to have much bearing on BT's capital investment in its access network.
21. A better approach would be to project forwards capital costs on the basis of a variety of other non-volume factors that are relevant for each charge control period such as the cyclicity of duct maintenance programmes.
22. Sky is also concerned that any new model may not be able to reassign dynamically common costs between fixed access services and other services which share the same common costs. This issue has arisen in leased lines markets with respect to common duct costs that are shared between Traditional Interface Symmetric Broadband Origination ("TISBO", i.e. Partial Private Circuits or "PPCs") and Ethernet services including Alternative Interface Symmetric Broadband Origination ("AISBO"). As TISBO volumes fell and AISBO volumes increased, certain common duct costs allocated to TISBO remained invariant when they should have reduced and been allocated to AISBO.

23. As a result, Ofcom has had to make significant one-off common cost adjustments before setting charge controls for TISBO and AISBO. The approach to the next WLR and LLU charge controls should avoid any misallocation of common costs by ensuring that they are reassigned dynamically to the appropriate services.

DISCRETE ISSUES

24. Ofcom's current approach to certain key discrete issues could be improved upon in the next charge controls for WLR and LLU:
- a) Ofcom's method for forecasting **line volumes** – a key determinant of prices given the large fixed and common costs present in BT's access network – for the current LLU and WLR charge controls was inadequately reasoned. While Ofcom cited a variety of line volume data, forecast information and key trends, it failed to show precisely how it used this information and how it quantified its key inputs into the overall line volume forecast. It is important that these deficiencies are addressed at the next charge control;
 - b) as copper commodity prices have increased, so too have copper scrap prices. Some of BT's **income from scrapping its copper cabling** appears as a negative cost in the LLU and WLR charge control cost stacks. Given the growing importance of this income – particularly as, in the future, more copper access lines could be removed from the access network to be replaced with fibre – it is reasonable to consider whether the current approach is the correct one or whether it is appropriate to depreciate copper cabling costs to some estimate of residual scrap value instead. Should Ofcom decide to continue with the current approach of merely apportioning scrap income back to copper access services, then greater scrutiny in how that income is forecast for the relevant period would be required;
 - c) the **line length differential** was first implemented by Ofcom in the 2005 LLU and WLR charge controls but has been reduced at subsequent charge control reviews in 2009 and 2012. However, the BT evidence to support the differential appears to be contradicted by other information, such as broadband speeds data. Therefore, it is appropriate for Ofcom to consider further the appropriateness of the adjustment and, should it continue to be justified, then it should conduct a thorough review of the available evidence in order to arrive at a more reliable estimate of the differential; and
 - d) Ofcom may consider that it is appropriate for it to aim towards the lower end of its forecast range of cost efficiency improvements when setting the **efficiency rate** to apply to the charge controls in order to maintain incentives on BT to beat that rate and keep the additional benefit (i.e. greater profit). However, these incentives – to better the target efficiency – would be equally strong wherever Ofcom aimed within its forecast efficiency range (or, indeed, outside of this range). On a proper basis, therefore, aiming for the mid-point or above would also be justified.

COST OF CAPITAL

25. Since the credit crisis, macroeconomic conditions and government interventions have been such that key determinants of the components that are used to calculate WACC estimates – such as ILG rates as a proxy for the RFR – have deviated for sustained periods from historical averages. Regulators, in turn, have made allowance for the exceptional circumstances by making upward or downward adjustments to these proxies before concluding on the appropriate number to include within their cost of capital calculations. In Sky's view, Ofcom could introduce further structure and evidence-based support for a decision that necessarily entails a degree of judgement.
26. Moreover, in reviewing its methodology, Ofcom should consider further whether all of BT's higher debt premium is attributable only to higher default risk or whether it is plausible that a variant and higher debt beta may have also played some part. Even if Ofcom were to conclude that higher default risk was the sole cause, then this could justify aiming lower in the debt premia range.
27. In continuing to disaggregate BT's cost of capital in order to arrive at separate WACC estimates for Openreach WLR and LLU charge controls and other regulated charges, we consider it appropriate to assess whether there are any suitable comparator companies (in addition to utilities) and whether BT's business risk has evolved such that there is now a case for a greater gap between the WACC of Openreach's copper access business and that of other parts of BT. For example, BT's acquisition of sports rights or its roll out of NGA could increase group-wide riskiness while the risk associated with Openreach's copper access business remains the same and, hence, could justify a greater gap⁵.

COST ORIENTATION

28. Sky considers that there are two eventualities which may merit the introduction of a cost orientation remedy for products that may also be subject to a charge control:
 - a) where, for a basket of services subject to one charge control, the concomitant sub-caps, sub-baskets and inertia clauses are insufficient to prevent the prices of individual services from being excessive⁶; and
 - b) where it is possible that there will be a period where one charge control has elapsed and the new one has yet to start.
29. For the first of these issues, Ofcom should explain and demonstrate clearly whether the design of any charge control baskets is such that a cost orientation condition is not merited. We note that, in the current Business Connectivity Market Review ("BCMR") and Leased Line Charge Control ("LLCC") consultations, Ofcom has justified its decision not to impose a cost orientation condition on the basis that the design of its charge control

⁵ Should Ofcom adopt an anchor pricing approach that assumes that there are only copper access lines and no fibre access lines, then it would be appropriate to ensure that the WACC that is applied to the WLR and LLU charges is devoid from any elevation that stems from NGA risk.

⁶ We note that, currently, Ofcom typically relies upon Distributed Standalone Cost ("DSAC") as a benchmark by which to assess whether prices are cost oriented.

baskets was sufficient to prevent prices exceeding DSAC. However, at no stage, has Ofcom provided any evidence to support its conclusions.

30. In relation to the second of these issues, there was a significant gap between the start of the current LLU and WLR charge controls and the expiry of the previous one. Ofcom implemented all other relevant significant market power (“SMP”) remedies in the WLA and WFAEL markets much earlier – it was only the charge controls that lagged behind.
31. Ofcom concluded that a ‘basis of charges’ or cost orientation condition was not required because, in part, it would be disproportionate, in its view, to apply both a charge control and a cost orientation remedy (even though it was several months before the charge control came into effect and its final design and, hence, its capacity to prevent prices from being excessive throughout the charge control period remained uncertain).
32. BT made voluntary pricing commitments for the period where no charge control was in operation. These commitments maintained a level of pricing which was significantly above the prices that would have been in effect had the new charge controls been imposed on time⁷.
33. As a result of these purely administrative issues, BT’s customers paid higher prices than would otherwise have been the case. In these circumstances, a cost orientation remedy could have provided some backstop protection from excessive prices in the interim.
34. However, benchmarking whether prices are cost oriented during any interim period by reference to DSAC is unlikely to be appropriate. A cost orientation condition for this period would need to mimic the role of a charge control to some extent and therefore the right cost benchmark would be one that is closer to Fully Allocated Costs (“FAC”) than to DSAC.

WBA MARKET 1 CHARGE CONTROL

35. Unlike fixed access markets, WBA markets are more contestable and assets are replicable. As a result, market entry continues to occur as is evident from the current unbundling of more local exchanges by some LLU operators. As such, if Ofcom considers it appropriate to continue with a charge control for Market 1 (or extend this remedy to Market 2 as well), sending appropriate build-buy signals is arguably more important than it is for wholesale fixed access markets.
36. While it may be considered that the MEA is one based on fibre and, hence, the appropriate reference point by which to set charges, this is not the technology that LLU operators deploy when unbundling exchanges in these markets. Nor is it the technology that BT has used when upgrading its legacy WBA services. In both instances, ASDL2+, MSANs and Ethernet backhaul have been the technology choice.

⁷ It is possible to determine this because Ofcom’s charge control modelling for the new charge controls started from the expiry date of the old charge controls.

37. Moreover, any fibre-based delivery (in Markets 1 and 2 at least) of WBA services by BT appears to be partially dependent on state funding via BDUK and, as such, cannot be considered the technology choice of a hypothetical new entrant.
38. In this context, a fibre-based MEA approach to any WBA charge control is unlikely to be justified. Ofcom's anchor approach to the current WBA charge control is also unsuitable as it adopts a hypothetical ongoing model of BT's legacy network (ADSL, DSLAMs and Partial Private Circuits) even though, in reality, it is largely depreciated.
39. Similar to Ofcom's proposed approach to the next NCC (should one be required), we consider it appropriate to base any future charge control on the costs of the technology that entrants actually deploy and not on either a more costly version of BT's legacy technology or a technology that can only be viably rolled out with state funding – both of which could induce inefficient market entry.

Sky

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