BT's Response to Disputing CPs' Responses

1. This submission sets out BT's response to a number of the issues raised by the Disputing CPs[1] in their respective responses to Ofcom's Draft Determinations[2] in respect of the Ethernet Disputes; in particular, this submission addresses the points raised by the Disputing CPs that, in terms:

   a. BT should be required to pay interest on the amounts that the Disputing CPs are deemed to have overpaid;

   b. the award to the Disputing CPs should be calculated by reference to the difference between price and FAC, not the price and DSAC;

   c. holding gains should be taken into account in determining the costs attributed to Ethernet services;

   d. where errors have been found in the costs ascribed to Ethernet services then DSAC should be adjusted in line with the ratio of FAC:DSAC and not by the absolute increase in FAC;

   e. Ofcom should apply the RAV adjustment when calculating the costs to be used to assess compliance;

   f. no weight should be attached to the nascent nature of the Ethernet market or BT's interactions with Ofcom;

   g. the Disputes should be extended to cover other products and services; and

   h. no allowance should be made for the nascent nature of the Ethernet market in the early years covered by this dispute.

2. Ofcom should not presume that BT accepts any point made by the Disputing CPs, unless such point is specifically addressed and explicitly accepted in this submission.

[1] TalkTalk, BSkyB, Virgin Media, Verizon and Cable&Wireless Worldwide.

[2] BT adopts, for the purpose of this submission, and unless the context otherwise indicates, the definitions and nomenclature contained in BT's response to the Draft Determinations submitted to Ofcom on 20 April 2012 ("the 20 April Response").

INTEREST

Introduction

3. The Disputing CPs all criticise Ofcom's Draft Determination for proposing that BT not make any payment of interest. The Disputing CPs urge Ofcom to direct that BT pay interest on any sums which Ofcom determines to be paid under section 190(2)(d) of the Communications Act 2003 ("the 2003 Act"). In addition, the Disputing CPs make a number of claims about what the appropriate rate of interest should be.

4. Ofcom was plainly right in the approach that it took in the Draft Determinations to have regard to what the parties had themselves previously agreed as to the payment of interest in the present circumstances. It is consistent with Ofcom's previous approach and it would be wholly unfair on BT to now change the clear understanding the parties had, i.e. that no interest would be payable in the event of a determination by Ofcom adjusting payments between the parties. The unmeritorious nature of the Disputing CPs' claim to interest can be seen by the spurious legal arguments advanced (for example, in the case of TalkTalk, the application of the Unfair Contract Terms Act 1977 ("UCTA 1977")).

5. In the paragraphs below, BT responds to the various arguments which the Disputing CPs make for interest to be paid, namely:

   a. the effects of the contractual provision and Ofcom's statutory duties;

   b. whether an attack on the contractual provision falls within the scope of the Disputes;

   c. whether the contractual provision was imposed on the Disputing CPs as part of an exercise by BT of the "Significant Market Power" ("SMP") BT has been found to have on the relevant market;

   d. whether, in provisionally deciding against ordering BT to pay interest, Ofcom has acted consistently with its previous decisions, has fettered its discretion, has adopted a policy without consultation, or has failed to consider the previous submissions of Sky and TalkTalk;

   e. whether the term is an exclusion or limitation clause or assistance is to be otherwise gained from the UCTA 1977; and

f. the interest rates contended for by the Disputing CPs[3]. BT should make clear at the outset that it does not accept any interest should be payable, but in any event none of the rates proposed (except, perhaps possibly, the Oftel interest rate) have any legal, logical, economic or policy justification for their application to these Disputes.

Should interest be directed to be paid?

The Contractual Provision

6. The obligation to pay interest at all, and the amount or rate of any interest payable are matters which are ordinarily governed by the contract between the parties. This contract (in the second sentence of clause 12.3 of the Contract Conditions) has clearly prescribed that interest should not be paid where Ofcom reaches a Determination requiring a readjustment of payments. Moreover, the contracting parties have specifically chosen a different solution to other situations where either the purchasing party defaults on payments (clause 12.2 of the Contract Conditions) or BT has to refund payments (first sentence of clause 12.3). This distinction was understood at the time the contract was negotiated (as reflected by the very material that Sky and TalkTalk relies upon[4]). The CPs could have challenged this, they have chosen not to. (This is dealt with at greater length below.)

7. Further, there is nothing inherently illogical or unreasonable in a contract drawing a distinction between the interest payable, on the one hand, where an obligation which is clearly set out in the contract (and which the parties fully know and understand in advance) is breached (e.g. a failure to pay a contractual sum when due) and the position, on the other hand, where there is a retrospective readjustment by Ofcom (or by any other regulatory authority or body) of the amounts which a party is required to pay, which replaces the existing obligations applied under the contract. For example:

   a. In the case of an Ofcom retrospective adjustment, the parties will not know until the time of that adjustment, whether or not the amounts paid are in fact going to be adjusted, and if they are, what the size of that adjustment will be. Nor do they know generally how much time is likely to elapse before the readjustment. Indeed, they may not know that a dispute is likely to be raised about the payment at all.

[3] Variously:
(i) BT's relevant cost of capital, what TalkTalk describes as "RoBT WACC" (11.4%).
(ii) The Interest Rate prescribed by the contract in other (totally different) circumstances (HSBC + 4%)
(iii) The Late Payment of Commercial Debts Act rate (Bank of England Base Rate + 8%)
(iv) The Oftel interest rate in other contracts, such as BT's Standard Interconnect Agreement (LIBOR + 3/8 %)

[4] TalkTalk's Annex C and the spread-sheet attached to Sky's Annex 2.

b. This lack of advance knowledge creates considerable uncertainty for parties. It makes it difficult for them to make appropriate provisions at the time. A requirement to pay a large sum plus interest in one go following a readjustment can cause significant problems placing the party ordered to make a repayment in a far worse position than if the adjustment had occurred prospectively at the time at which the terms complained of came into effect. In those circumstances contracting parties are entitled to agree between themselves that there should be no interest paid by any party affected by an adjustment.

c. Further the clause reflects the recognition by all parties that regulatory decisions are to an extent outside the direct control of the parties, whereas matters such as overdue payments are within one or other of the parties' control.

8. Moreover, contrary to the assertion, for example, of TalkTalk[5], the agreement in the present case plainly works both ways. It states "*interest will not be payable on any amount due to either party as a result of that recalculation or adjustment.*" [emphasis added]. If Ofcom had held that the charges paid by the CPs were too low, and had required the CPs to pay more to BT retrospectively than they had paid originally, Clause 12.3 would prevent BT from recovering interest on the sums paid by way of the adjustment; the clause operates symmetrically.

9. This was well understood at the time. For example the very spread-sheet Sky has introduced at Annex 2 to its Response relating to contract discussions in 2008, states in terms that Easynet were asserting "*No interest available on retrospective price changes – can go either way but we may want interest to be incurred. To be discussed....*" [emphasis added]. Great care has to be taken with this spread-sheet as the majority of comments on clause 12.3 plainly relate to the terms of the first sentence of clause 12.3 (where interest was payable)[6]. What is however clear is that no one was asserting that the second sentence of clause 12.3 would only work in BT's favour. To the contrary Easynet was asserting the direct opposite.

10. The Competition Appeal Tribunal ("the CAT") in the 080/0845/0870 numbers case ("the 08x case")[7] held that private law rights are a factor to be considered by Ofcom when determining

[5] Footnote 57 of the TalkTalk Response.
[6] For example the CWW comments all relate to when under the first sentence of clause 12.3 interest should start to run – i.e. whether it is the date when agreement of an overpayment is reached or "*the date that the CP actually overpaid*". See further section B (3) below.
[7] [2011] CAT 24.

how to resolve a dispute[8]. (As Ofcom is aware, the judgment of the Court of Appeal in that case has yet to be handed down.) That of course was not specifically raised in the context of an award of interest but was relevant to the question of how the substantive issues in the dispute should be resolved. BT contends that the position here, in relation to an award of interest, is even more compelling.

11. For example, unlike other statutory schemes (e.g. sections 31 of the Supreme Court 1981, section 69 of the County Court Act 1984 and section 49 of the Arbitration Act 1996), where express provision is made for the payment of interest, section 190(2)(d) makes no provision for its payment. Nor does the CRF lay down any requirement that a National Regulatory Authority must make provision for interest[9]. The obvious statutory intention was that the issues of interest should normally follow the contractual arrangements between the parties. Where the contract provides, as clause 12.3 does, for no payment of interest in the specific situation where there has been an adjustment as a result of a finding by Ofcom, it would be wrong for Ofcom to ignore the provision to that effect[10].

12. Indeed, the 08x case itself demonstrates that the payment of interest is not an automatic remedy, even where the parties have expressly provided for payment. Despite clause 12.7 of the SIA expressly providing for the calculation of interest at the "*Oftel Interest Rate*", the Tribunal expressly held that no interest should be payable[11]. This is wholly consistent with the fact that, in the case of an Ofcom retrospective adjustment, the parties will not know until the time of that adjustment, whether or not the amounts paid are in fact going to be adjusted, and if they are, what the size of that adjustment will be.[12]

13. Nor, contrary to the submissions made by the Disputing CPs, is an award of interest necessary in order to disincentivise future overcharges. BT has already emphasized in its 20 April Response that, had it known at the time how Ofcom was going to interpret and apply

[8] Ibid. See for example §§418(i) and 444.

[9] This is not surprising since the vast majority of anticipated disputes would be forward looking rather than retrospective adjustments stretching back many years. This point is made without prejudice to the contentions BT makes in its Ground of Appeal and Skeleton Argument in its application for permission to appeal to the Court of Appeal in respect of the CAT's PPC Judgment,

[10] The position did not arise in the PPC case since there was an express contractual provision, relied upon by Ofcom, in its Final Determination (e.g. page 161 paragraph 3) for BT to pay "*interest calculated at the rate specified in paragraph 9.7 of the Agreement*."

[11] §457 of the Judgment.

[12] Some of the CPs have sought to argue that the 08x case is to be distinguished from the present case. The CPs rely on the fact that in the 08x case there was no finding of SMP and further that there was an inconclusive welfare assessment in that case. BT accepts that those are relevant distinctions from the present case. However, those distinctions do not mean that it would be correct for Ofcom to disregard the parties' agreement that no interest should be paid. To the contrary the decision (in specifically refusing interest) reflects the acknowledged uncertainty there is as to how adjustments might operate. If the parties themselves agree that, in respect of a remedial matter such as interest, none should be payable, then this is not something which should be set aside by Ofcom.

Condition HH3.1 now, it would have sought to comply with Ofcom's current interpretation.[13] It is only because of the uncertainty surrounding the application of Condition HH3.1 in relation to Ethernet (and other markets / products) that the situation has arisen where a potential adjustment is being contemplated by Ofcom.

14. Without prejudice to any future submissions BT may make as to jurisdiction[14], if there is genuine concern about the incentives which may be created for the future, it is perfectly open to Ofcom to explain that the exercise of their regulatory duties in this case has led it not to interfere with the parties' contractual position, and at the same time to indicate (without fettering its discretion for future cases) that it may be appropriate to award interest in future cases. The need for incentives does not require an award of interest in the present case.

15. The Disputing CPs reliance on what is called the "PPC Payments case" (Ofcom's determination 25 January 2007)[15], but which BT will call the "Thus 2007 Determination", in order to suggest that BT should be forced to repay working cost of capital through interest payments[16], is thoroughly misguided. The Thus 2007 Determination makes clear that the issue of interest payments was completely outside the scope of that dispute[17]. The Thus 2007 Determination was specifically considering the fairness of the contractual payment terms and made the relevant findings necessary only for that.

16. Ofcom has not made any enquiries in the present case in relation to economic harm, nor in relation to counter-restitution. They have not been required by Ofcom to make counter-restitution in relation to those products purchased where BT charged less than it might have done. Again, these are all strong harm factors pointing in favour of upholding the outcome specified and agreed under the contractual terms in this case, particularly when those terms relate solely to the payment of interest as a result of a regulatory decision.

17. Finally, Sky makes the point that Ofcom's reasoning is internally inconsistent[18], based on an assertion that Ofcom's Draft Determinations found that interest should be payable, but then found, based on the contractual provision, that no interest was due. It is untenable to suggest that Ofcom made any provisional finding that interest should be payable. Ofcom was simply formulating its position that the matter of interest should be governed by the contract when it

[13] See for example §§ 26-27, 62, 79, 91-99 and 97-99 BT's 20 April Response
[14] For example by way of BT's appeal to the Court of Appeal of the Competition Appeal Tribunal's PPC Judgment.
[15] Determination of a dispute between THUS and BT about payment terms for PPCs, IECs and IBCs dated 25 January 2007.
[16] See e.g. §4.26 and 4.27 of TalkTalk's Response.
[17] See § 4.123 of that Determination.
[18] See § 98 of Sky's Response.

said that it proposed to direct "*that interest should be paid on the requirements in accordance with the contractual provisions entered into by the Parties*"[19].

The Scope of the Dispute

18. The fairness of the clauses within the contract, and in particular the fairness and reasonableness of Condition 12.3 was never included in the scope of the present Disputes. Ofcom has correctly acknowledged this in §7.19 of the Ethernet 2 Provisional Conclusions, where it is expressly stated in respect of clause 12.3 and interest "*whether the contractual terms on which BT provided the services was fair and reasonable is outside the scope of this Dispute*". This is absolutely clear, not only from Ofcom's own definition of the scope of the Disputes, but also from the contents of the Disputing CPs' own dispute references which make no mention of any challenge to clause 12.3[20].

19. A number of Disputing CPs suggest[21] that it would be wrong for Ofcom to hold that the question of whether the contractual terms were fair and reasonable was outside the scope of the dispute, Sky baldly asserts that:

> "*Ofcom can and should issue a direction under section 192(2) (b) 'fixing the terms or conditions of transactions between the parties to the dispute', which has the effect of striking out the clause of the standard BES agreement that excludes the payment of interest and requiring BT to include in the standard agreement a clause that entitles the communications providers to interest in the event of overcharging by BT*"[22]

20. It would be a serious irregularity for Ofcom now to change the scope of the dispute to include any consideration of whether clause 12.3 was fair and reasonable. Moreover, there has been no consultation with other parties to the contract who would be affected by a change[23].

21. The inherent dangers of parties being asked to respond to very different disputes than those originally scoped is well illustrated by the initial 0800 case which led to much procedural

[19] See § 14.37 of the E1DD.
[20] For example TalkTalk and Sky's submission of 27 July 2010 merely asks for repayment of sum "*together with interest on that sum at such a rate and for such a period as may be appropriate and just.*" That is a plea akin to one for interest under s35 of the Supreme Court Act 1981 (for which of course there is, as discussed above, no statutory equivalent in the 2003 Act). What it is not is a request that the contractual provision in clause 12.3 should be declared unfair and unreasonable.
[21] see e.g. footnote 52 of TalkTalk's Response.
[22] §87 of Sky's Response.
[23] Any change to the contract may arguably apply to all purchasers of the products as a result of BT's SMP obligations and the BT Undertakings, specifically the EoI requirements

wrangling and eventually led to the CAT accepting that Ofcom had, to BT's prejudice, changed the scope of the dispute[24].

22. In any event there has been no negotiation (other than the now historic discussions in 2008) between the parties, prior to the referral of the disputes, about the terms of clause 12.3 prior to any dispute being referred to Ofcom[25][26]. Ofcom's guidelines require this[27] and it did not happen.

23. There are, therefore, insurmountable problems in now extending the scope of the disputes to include any question over the fairness of the contractual terms, including terms as to interest. Ofcom is entirely right therefore to have rejected any attempt by the Disputing CPs to include the issues of the fairness and reasonableness of the contractual terms in these disputes.

Whether the contractual provision was imposed by the exercise of SMP

24. The Disputing CPs suggest that the contractual provision was imposed on them in an exercise of BT's SMP in the market. TalkTalk suggests at paragraph 4.29 that "*BT, as a player with significant market power, is in effect able to impose broadly whatever term it likes".* Further, at paragraph 4.30 of its Response it says that, "*Although TalkTalk did ultimately sign various contracts containing the Interest Exclusion term, TalkTalk certainly did not consider the terms reasonable.... TalkTalk had little or no commercial choice but to sign up to the contract....*".

25. In fact, as already noted above, the material that both TalkTalk (in Annex C) and Sky (in Annex 2) have produced is potentially misleading unless it is recognised that most of the discussions related, <u>not</u> to the term in question here (namely the second sentence of clause 12.3 i.e. no interest was to be payable by either party in the event of a determination by Ofcom) but to the first sentence, which dealt with any entirely different point (namely from <u>when</u> exactly any interest on a retrospective repayment by BT would actually run). For example, if one considers the entry, "*CP Suggested Resolution Remedy*" (mentioned in both Annex C of TalkTalk's response and Sky's Annex 2 spread-sheet against Condition 12.3), that states, "*C+W: Text to read .... for the period beginning on the date that the CP overpaid BT and ending on the date BT actually makes the repayment*". That relates entirely to a suggested variation of the

[24] See §§103 to 107 [2010] CAT 17.

[25] It would be totally wrong to consider that the discussions that took place in 2008, and to which the CPs refer in their Responses, means that there is some form of "live" dispute over BT's terms and conditions in 2012. BT explains in §§24-29 below why in any event what happened in 2008 does not have the significance that the CPs claim.

[26] The contract was reviewed in 2010; however no CP raised this interest provision (i.e. the third sentence of clause 12.3) as an item for review. The contract is currently being reviewed and this interest provision has been the subject of review: the current status is that BT and the negotiating CPs have "agreed to disagree".

[27] E.g. §2.4 of the 2011 Guidelines.

first sentence of clause 12.3[28]. In short the majority of the material apparently relied on by these two CPs relates to a completely different point.

26. BT accepts that some of the discussion plainly did relate to the second sentence of clause 12.3. However, it is highly relevant that:

    a. nobody was actually suggesting that this second sentence was all in BT's favour (as discussed above, to the contrary, Easynet was asserting that it had a two way effect); and

    b. the CPs do not suggest that CPs were being forced to agree because of BT's SMP.

    Moreover, as with any contractual negotiation, BT was offering up concessions on certain clauses and the CPs on other clauses. This can be seen from the very spread-sheet that Sky has produced at Annex 2. To give but one example[29], in respect of clause 2.2, Thus wanted to reduce the termination notice period from 2 to 1 month to which Openreach agreed. Far, therefore, from BT refusing to countenance any changes to the contract, there was plainly exactly the sort of give and take that one would expect in a contract negotiation.

27. What this material therefore plainly demonstrates is that the contract term was not being unilaterally imposed. Instead there was a significant degree of negotiation taking place. Given that contractual "give and take" was plainly occurring, it would be wholly wrong and unfair on BT now to adjust one clause of the contract without taking into account that concessions will have been made elsewhere by BT as a compromise in the negotiating process.

28. In any event it is simply wrong to suggest (as for example TalkTalk does[30]) that "*BT as a player with significant market power, is in effect able to impose broadly whatever terms it likes*". All the Disputing CPs have known since the H3G No 1 case[31] that contractual terms could be changed under Ofcom's s.185 dispute resolution powers. Indeed the very Thus 2007 Determination, to which the Disputing CPs refer, demonstrates this in practice in 2006/2007. None of the Disputing CPs sought to challenge clause 12.3 by this process which they could and should have done if they had truly felt they had no option but to sign up to BT's terms. The Disputing CPs obtained the compromises they really wanted in the negotiations and were

[28] Thus the CWW comments would lead to first sentence of clause 12.3, being amended as follows: *"the* [CP] *may charge daily interest on late repayments for the period beginning on the date ~~on which the parties acting reasonably agree BT shall make the repayment~~ that the CP overpaid BT and ending on the date BT actually makes the repayment*". It would not affect the second sentence of clause 12.3.

[29] There are many more examples. The Sky spread-sheet does not even record all the material relating to the negotiations since they went on after the period recorded in Sky's spread-sheet.

[30] See §4.29 of its Response.

[31] [2005] CAT 39.

content to let BT have the other points, such as the second sentence of clause 12.3. If they had truly felt aggrieved they could have raised a dispute, none did.

29. Indeed, as noted above, the contract itself specifically allows the Disputing CPs contractually to review the contract terms. For example clause 17.4 expressly provides for CPs to review the terms prior to 1 March 2010 – this interest term was not reviewed at that time[32]. All of that is without prejudice to a dispute reference to Ofcom and no reference was made. It is, therefore, nonsense to suggest that the Disputing CPs have had clause 12.3 arbitrarily imposed upon them by BT. Ofcom should recognise the Disputing CPs arguments for what they are: an attempt to circumvent the contract to which they signed up, but which they would now prefer Ofcom to ignore. They should not now be allowed to complain that the term is unfair.

Consistency with past Ofcom practice

30. Contrary to the complaints made by the Disputing CPs[33], Ofcom has in fact acted consistently with its previous decisions as it has stated in § 14.37 of the Draft Determinations by leaving the matter as one which is to be governed by the contractual terms on interest. For example In the PPC1 case Ofcom carefully considered the position of interest on repayments. Ofcom stated in its Final Determination, "*In considering whether to require BT to pay interest on the overpayments in the Draft Determinations, we have regard to the terms and conditions on which the Disputing CPs purchase PPCs from BT...*". This included an express term as to what was to happen to interest on any repayments[34].

31. The disputing CPs in that case (including several of the Disputing CPs) sought to challenge the contractual interest rate in the PPC1 case suggesting that it should be left to the parties to negotiate (though they also clearly indicated that Ofcom should not apply the contractual provision but instead proposed a rate of LIBOR + 4% which was the Default Rate in the SIA contract – exactly the same argument as pursued here for HSBC base +4%[35]. Ofcom rejected that approach in favour of the actual contractual rate noting "*… the Agreement clearly envisages a situation such as that arising in the Disputes occurring (i.e. past charges for PPC services being adjusted in the future) and sets out that where this occurs BT should recalculate the charges using the new charges and calculate interest using the Oftel interest rate*". In this case clause 12.3 also "*clearly envisages a situation such as that arising in the Disputes*

[32] See footnote 27 to this submission.
[33] See e.g. TalkTalk Response § 4.3.
[34] §8.84 of the Final Determination.
[35] See Olswang's submission on behalf of the CPs in that case dated 2 June 2009 at §7.38.

occurring (i.e. past charges for PPC services being adjusted in the future)" but has determined that neither party should get the benefit of any interest.

32. Ofcom's approach of following contractual provisions as to interest not only accords with regulatory consistency but also is an important aspect of regulatory certainty. (BT has referred at some length to the importance of this legal principle in its 20 April Response at §§31-34.) If parties cannot know in advance what principles Ofcom is to bring to bear on a particular situation, then contractual agreements cannot be properly negotiated. If the parties have agreed one thing as to interest, but the other party can completely circumvent that agreement by means of raising the question of an interest provision in a dispute about something else (i.e. cost orientation), then the very real risk is that contractual agreements will be perceived to be of little value and Ofcom will be sucked into more and more disputes. Ofcom was therefore entirely correct to take the approach it did in the Draft Determinations.

33. It is quite wrong to suggest that Ofcom has somehow fettered its discretion by referring to the contractual position.[36] There can be no doubt that Ofcom has considered the individual facts of the present case and the submissions of Sky and TalkTalk made to it on the subject of interest, and it will of course do so when it issues its Final Determinations. For the reasons expressed above, the contractual solution is an appropriate one in the circumstances of this case.

34. CWW suggests that simply following the contractual terms will give rise to inconsistency in outcomes in the determination of these kinds of disputes[37]. However, there can be no objection to Ofcom giving effect to what the parties have agreed, provided that Ofcom considers that the outcome is an appropriate one. Contract terms give rise to different outcomes in many situations, but it is not part of Ofcom's regulatory duties simply to ignore the contract and impose new terms across the board. TalkTalk considers that Ofcom may have adopted a reasoned policy without consultation[38]. However, giving effect in the circumstances of a particular case to contractual provisions is neither surprising nor is it an incorrect approach. On the contrary, it is an obvious one, on which no consultation is needed or required.

[36] §4.10 of TalkTalk's Response.
[37] §147 of CWW's Response.
[38] §4.5.1 of TalkTalk's Response.

Whether the term is an exclusion or limitation clause and or any assistance is to be gained from UCTA 1977

35. TalkTalk make the suggestions that the terms of UCTA 1977 apply to an assessment of reasonableness under any Act, including the 2003 Act,[39] and that section 11(4) of UCTA 1977 applies because there has been a restriction of liability to a specified sum of money[40]. Neither of these assertions stands up to scrutiny. There is absolutely no support for the first claim that the UCTA provisions apply to any Act (and indeed it would run contrary to every tenet of statutory construction). The provisions of UCTA 1977 are, unsurprisingly, dealing with particular matters none of which arises in the present case: namely, contractual exclusions of liability for negligence, or terms which purport to permit the rendering of a contractual performance substantially different from that which was expected. There is no basis whatever for claiming that statutory provisions designed to deal with those circumstances are relevant to the question of what is fair and reasonable in Ofcom's dispute resolution proceedings.

36. As regards the second claim (that, section 11 (4) of UCTA 1977 applies) section 11(4) is only relevant when section 3 applies (see e.g. section 11 (1)), which of course it does not in the present circumstances. Section 3 (2) (a) which deals with clauses in contract seeking to "*exclude or restrict any liability*" states in terms that it is limited to situations when a party, whose standard terms they are, is "*...himself in breach of contract, exclude or restrict any liability of his in respect of the breach*" [emphasis added].[41] The second sentence of clause 12.3 is plainly not a limitation of liability clause (indeed the issue of limitation is expressly addressed in an entirely separate clause of the contract: see clause 13).

37. There can be no suggestion that BT is in breach of contract. Ofcom's Draft Determination is dealing with a breach of a regulatory obligation which is entirely separate and distinct from any contractual breach. Moreover section 3(2)(a) is a restriction on liability in respect of the breach – damages payable for breach of contract.

38. As explained above, the clause is simply a provision dealing with the payment of interest by either party in the case of a retrospective adjustment by Ofcom. It does not exclude or limit the liability of a party in breach of a contract. Ofcom has expressly refused to consider the

[39] §4.33.1 of TalkTalk's Response.
[40] §4.32 and footnote 58 of TalkTalk's Response.
[41] TalkTalk does not claim than the interest provision in 12.3 of the Contract is anything other than "*properly understood as an exclusion or limitation clause*" and so does not even raise an argument based on section 3 (2) (b) of the Act. In any event by the parties mutually agreeing not to expect interest from each other in the event of a determination by Ofcom, BT is not rendering a contractual performance substantially different from that which was expected.

payment under s.190(2)(d) as any form of compensation but in effect as a restitutionary remedy.

The interest rates contended for by the Disputing CPs

39. BT considers, as explained above, that it would be wrong to award interest on any payments that it is ordered to make to the Disputing CPs. Further and without prejudice to that position, any award of interest, other than, perhaps, at most the Oftel interest rate, would be illogical and demonstrably flawed.

40. Some of the Disputing CPs seek to rely on the Thus 2007 Determination. However, in that case Ofcom did not decide to award interest at any particular rate and held that that the whole issue of interest was outside the scope of that dispute[42]. Accordingly, there is no basis for that decision to be used as a ground for awarding any form of interest in these Disputes.

41. The payments that Ofcom ordered BT to make in that case related to the contract terms requiring payments quarterly in advance with 30 days to pay, where cost of capital is clearly relevant. In the present case, if Ofcom decides to order payment of sums to the Disputing CPs, they will obtain significant sums in one go considerably after the charges were made to CPs, in circumstances where there has been no inquiry in relation to economic harm or counter-restitution and where there was uncertainty about the possibility of adjustments by Ofcom. Those circumstances are very different from the circumstances in the Thus 2007 Determination case. To use that case as a justification for applying a rate reflecting BT's or the Disputing CPs' cost of capital, when interest was never considered and in any event the very findings made were entirely different, would actually be a complete failure of regulatory consistency and certainty.

42. Likewise the Late Payment of Interest of Commercial Debts (Interest) Act 1998 has absolutely no bearing since it applies only to "*a debt created by virtue of an obligation under a contract to which this Act applies to pay the whole or any part of the contract price....*" (s.3(1) of that Act). However, there is no contract price or contract debt which arises in this case. Likewise it is completely illogical to refer to and rely upon an interest rate in the Connectivity Contract (i.e. the Interest Rate defined in the Schedule 1 Definitions as 4% above HSBC base) which the parties have expressly agreed should not be applicable to retrospective adjustments arising from an Ofcom Determination. This was the same argument that a number of the Disputing

[42] §4.123 Thus 2007 Determination.

CPs tried to pursue in the PPC1 investigation and which Ofcom rejected (see paragraph 31 above).

43. There might be a little more (but not much) logic in applying a rate like the Oftel interest (3/8% above LIBOR) since, as the name suggests, it is a recognised interest rate that goes back many years and has been used in BT's SIA since at least December 1996 and is present in a number of other contracts[43]. Ofcom has previously applied that rate (for example in the PPC1 determination), and it reflects a truer approximation of interest costs for trade credit for the larger entities in the Telecoms market like the CPs involved in this dispute. Of course there remains the fundamental problem that the contract itself eschewed this rate for this repayment, but if any arbitrary rate is to be used this rate has more merit.

Conclusions

44. BT has dealt with the Disputing CPs' arguments at some length in this response, not because of concerns about the strength of them (to the contrary they are plainly misguided as, for example, reliance on UCTA 1977 and the Thus 2007 Determination illustrate), but to demonstrate just how serious an error it would be for Ofcom now to depart from the Draft Determinations and award upward of **[£][C]** million additional unwarranted compensation. To do so at this late stage of the dispute resolution process, in contravention of what the parties have previously agreed and without, for example, any assessment of the economic consequences would be seriously flawed.

45. Ofcom was absolutely correct in its Draft Determination to take full account of the parties' contractual agreement that no interest would be payable where there were any retrospective adjustments arising from an Ofcom Determinations. To hold otherwise would be wrong for a whole series of reasons. Ofcom should therefore stick to its approach to interest, in the Draft Determinations.

AWARD BASED ON FAC NOT DSAC

Introduction

46. Sky and TalkTalk are clear in their criticism of Ofcom's use of DSAC as a test for determining whether or not there has been a breach of the basis of charges condition. This said, their

[43] For example, the PPC contract and the LLU contract.

views differ to a degree as to the cost orientation test they consider Ofcom should use instead; Sky and Verizon focus on FAC, which they say is the appropriate test to use[44], whereas TalkTalk suggests Ofcom uses three cumulative tests.[45]

47. The submissions advocating FAC (or something similar) run counter to the view expressed by Ofcom that it would be wrong now to depart from DSAC, because it would involve making assessments of liability for the past based on a new and much stricter test, which no one considered would apply at the time:

> "...*If we were now to change the maximum pricing level to FAC, we would be acting in a manner that is inconsistent with the position as understood by Ofcom, BT and the CPs that were paying the charges, at the time those charges were levied. It is also inconsistent with our previously stated position and regulatory practice."*[46]

48. To the limited extent that the Disputing CPs have attempted to deal with Ofcom's position at all, the arguments they rely on fall very far short of providing any satisfactory reason for Ofcom to conclude now that it would be appropriate to apply a much stricter test with retroactive effect, which would give rise to significant financial liabilities for BT many years after the event. The importance of the principles of certainty and non-retroactivity cannot be over-emphasized. BT summarises the relevant considerations below.

49. BT has already made submissions to Ofcom about the use of DSAC as a cost orientation test and the fact that BT was not made aware that DSAC would operate as a rigid ceiling[47], as Ofcom appears to consider that it should in the Draft Determination. Nothing in the comments made here is intended to detract from those submissions. That said, it was certainly never suggested by Ofcom at any stage (as Ofcom itself agrees) that the appropriate cost standard was FAC, or FAC supplemented by some percentage.

50. Ironically, there is at least some common ground between the Disputing CPs and BT. Both the Disputing CPs and BT contend that:

    a. what is appropriate for compliance with cost orientation obligation and the basis of charges condition, in any given market is a matter for individual assessment; and

[44] Sky's response § 9, Verizon response § 19. In contrast Virgin (its Response §5.4) and CWW (its Response §37) accept Ofcom's view that the appropriate measure of cost orientation is DSAC.
[45] TalkTalk's Response §§3.97-8.
[46] § 9.61 E1DD.
[47] See BT's 20 April response at §93.

b. comments from the PPC1 Judgment cannot simply be read across to other cases without first considering whether they are relevant and applicable.

Both the Disputing CPs and BT also argue that DSAC should not be applied mechanistically. The Disputing CPs then go on to draw conclusions opposite to those drawn by BT; for example, as to the direction in which a "non-mechanistic" application of DSAC ought to lead Ofcom.

51. Even leaving aside the objections of legal certainty and non-retroactivity, there are in any event very substantial objections to the approaches to cost orientation which the Disputing CPs advocate. These objections provide further reasons for rejecting the Disputing CPs' proposed approach.

52. The Disputing CPs' arguments against the use of DSAC and in favour of a different test can be grouped into to three main lines of attack:

a. FAC, or FAC with a particular percentage mark up (the percentage varies depending on whether or not Ofcom looks at individual products or groups of products), is a better cost orientation test than DSAC, because it promotes economic efficiency more strongly;

b. even if DSAC can be or is commonly be applied, it is for BT, as the party seeking to rely on it, to prove that alleged conditions relating to its use have been met (e.g. to demonstrate that a condition relating to price inelasticity compared with other related products is met); and

c. there is a problem of potential over-recovery if all related products are priced at DSAC.

53. Each of these arguments is without merit, as BT explains below.

Overwhelming legal objections to applying a new test at this stage

54. There are overwhelming objections to applying a new cost standard for the purposes of ascertaining compliance with a cost orientation condition which it was not known would be applied at the time the prices were set. If a new cost standard is to be introduced it has to have been made absolutely clear in advance and can only apply prospectively. Ofcom (as it accepts) has never previously considered that it would be appropriate to apply a FAC test, or some variant of FAC which set a ceiling below DSAC (for example the tests proposed by TalkTalk in its submission – "*ceiling on each/every individual product test set at FAC + 30%*" or

"*ceiling on WES/BES product group test set at FAC + 10%*"[48]). The only test previously referred to has been DSAC[49] which BT contends should in any event not be applied mechanistically.

55. The Disputing CPs' arguments in favour of using FAC (or closely related variants of FAC) as the test of cost orientation are largely a revamped version of the arguments that they made in the original PPC case. As §5.114 of that Final Determination (14 October 2009) records:

> "*...the Disputing CPs proposed that the overcharging assessment should be based on a comparison of ROCE (on a FAC basis) that BT has earned on its PPC services with BT's WACC. Where BT earned a ROCE that is higher than its WACC, the Disputing CPs argued that overcharging has occurred.*"

56. Ofcom correctly expressed "*concerns about placing too much emphasis*" on the use of FAC in the PPC Final Determination (§5.115) and went on to list them (at §§5.116 to 5.121). For example, as Ofcom noted, "*while accounting information may allow the calculation of an accounting ROCE, care may be needed in interpretation as it may not accurately reflect the 'the true' or underlying profitability for a range of possible reasons.*"

57. As noted by Ofcom in its Draft Determinations[50], the CAT held that FAC was not appropriate as a cost orientation test, on the basis that it was "*too rigid*"[51]. It is to be noted that the CPs in that dispute (who are mainly, though not exclusively the same CPs who are involved in these Disputes) did <u>not</u> seek to challenge Ofcom's approach to the use of FAC and its rejection of the CPs' original approach in the PPC Determinations. They did not appeal the point to the CAT, even though BT was itself appealing and the CPs intervened. It would in those circumstances, therefore, be unfair and wrong for Ofcom to accede to the Disputing CPs' arguments and, <u>retrospectively</u>, introduce a test based on FAC or FAC plus an arbitrary percentage.

58. Not surprisingly, the various responses of the Disputing CPs fail to point to any material suggesting that the use of FAC or a similar approach was ever intimated to BT by Ofcom. If such an approach were to be applicable, BT was entitled to prospective guidance as to how it is required to comply with the basis of charges conditions, and specifically Condition HH3.1, before it set its prices. It would be unfair and in breach of consistency, transparency, certainty and non-retroactivity if Ofcom were retrospectively to introduce a new test for cost

[48] See TalkTalk's Response §2.10.1.
[49] Though, the precise importance and application of this test Is challenged by BT as demonstrated by BT's Grounds of Appeal and Skeleton Argument in its application for permission to appeal to the Court of Appeal in respect of the CAT's PPC Judgment.
[50] E1DD §9.21.1.
[51] PPC Judgment §307.

orientation well after BT set the disputed prices, when BT was no longer able to do anything to comply with such a test. These principles were all outlined in section 2.2 of BT's 20 April Response. The proper place for the suggestions made by the Disputing CPs in suggesting a new approach to assessment of cost orientation is in the pending consultation on cost orientation which Ofcom said it would conduct in 2011/12,[52] but which is still outstanding or in response to market review and charge control consultations that discuss the particular form that an obligation should take. It would clearly be inappropriate to develop policy regarding a new approach to compliance using the dispute resolution process.

59. TalkTalk seeks to argue at§§3.101 to 3.121 of its Response that Ofcom should not feel obliged to apply DSAC in order to comply with its duties of regulatory certainty. The arguments that it makes are all misplaced.

a. The matters which TalkTalk relies on from the NCC Guidelines[53] all go to the issue of the flexibility with which DSAC is to be applied – a point which BT relies on both in its PPC appeal and in its 20 April Response. They are premised on the flexible application of DSAC, and do not refer to its substitution with another test. (Incidentally, the point being made briefly in the extracts from BT's RFS, set out in paragraph 3.105, is no more than that DSAC provides less pricing freedom than SACs or combinatorial tests. As is obvious, those extracts do not set out to discuss the flexibility with which DSACs are to be applied, or whether prices above DSAC may be consistent with a cost orientation obligation – a point which both the NCC Guidelines and the CAT's PPC Judgment support.[54])

b. The second point which TalkTalk makes is that the approach to assessing compliance is case-sensitive.[55] BT agrees that each case must be determined on its individual merits and this forms the basis of its argument for a more flexible application of DSAC. However, it would be quite a different thing altogether for Ofcom to depart from the DSAC cost standard, and to impose a far more stringent test retrospectively, for the reasons already outlined above.

c. The only illustration which TalkTalk gives of a situation where a test similar to FAC was used by Ofcom was the ISDN dispute (where Ofcom interpreted "appropriate mark-up"

[52] §4.14, Ofcom Annual Plan for 2011/12. http://www.ofcom.org.uk/files/2011/04/annplan1112.pdf
[53] See TalkTalk Response §3.103.
[54] BT's 20 April Response refers to these issues, e.g. at §§50, 51 and 63.
[55] TalkTalk Response §3.107.

as meaning EPMU[56]). That case was, as the quotation indicates one where BT had had "persistent SMP". The situation is very different from the present one where Ofcom set a cost orientation obligation in view of the new nature of the market and with a view to seeing how competition developed.

d. TalkTalk asserts that "*it was always clear that BT had to provide evidence that its prices were efficient*".[57] BT was made aware of no such thing, and there was certainly no requirement in the cost orientation obligation that the prices had to be economically efficient prices. TalkTalk is simply re-writing the obligation. TalkTalk's approach to what was economically justified is very different from that of BT's, focussing as it does exclusively on allocative efficiency. (This point is discussed in more detail below.) Whilst BT was always aware that it must comply with the obligation, its understanding was that Ofcom was not going to apply FAC or something similar, and that DSAC was the likely test (albeit, BT believed, to be applied flexibly to reflect market circumstances). If the position was fundamentally different, it was incumbent upon Ofcom to make that fact plain, so that BT could respond prospectively.

e. The suggestion that BT should simply have taken the approach of pricing at FAC and thereby avoided all compliance risk,[58] makes a nonsense of Ofcom's approach of applying a cost orientation obligation, such as the basis of charges condition, rather than price control in the first place, and ignores the economic and policy objectives that were intended to be served by giving BT appropriate pricing flexibility.

60. Ofcom's reaction in § 9.61 of the Draft Determination that it would be unfair to BT now to adopt a more exacting approach to cost orientation compliance is the correct one. The Disputing CPs have not provided any valid reasons for Ofcom to change its mind.

The cost standards proposed by the Disputing CPs would be wrong even if applied prospectively

61. The principal arguments raised by the Disputing CPs are identified above. BT explains below why Ofcom should give no credence to them.

The Disputing CPs for FAC rather than DSAC lack weight

[56] Ibid §3.115.
[57] Ibid §3.117.
[58] Ibid, §3.120.

62. The arguments for using DSAC in preference to FAC have been rehearsed on numerous occasions in the past. Ofcom's most recent response to the claims by the Disputing CPs that FAC is a suitable measure is set out in the Draft Determination at paragraphs 9.18 to 9.24 and 9.41-9.64 . Although the Disputing CPs make strenuous efforts to challenge Ofcom's approach, their arguments are wholly unpersuasive.

63. The thrust underlying the Disputing CPs' complaint about DSAC, and their corresponding preference for FAC, is that DSAC gives greater flexibility to the party which is subject to the cost orientation obligation than is reasonable in their view. They argue that DSAC permits prices which are higher than they would be if they were closely aligned to FAC. The Disputing CPs, of course, wish to maximise any repayments ordered in their favour in these Disputes.

64. It is acknowledged by at least some of the Disputing CPs that greater flexibility is warranted in cost orientation than would be provided for by simply applying FAC. For example, TalkTalk accepts at § 3.26 both that a cost-orientation obligation should not be interpreted as imposing as strict a constraint on pricing of individual products as charge controls, and also that the cost orientation obligation warrants more price flexibility. Nonetheless, TalkTalk then proceeds to limit DSAC and to criticise it for amongst other things not being "*linked to any economic concept*"[59] and not bearing "*any relationship to economic efficiency considerations*".[60] Other Disputing CPs also argue against giving DSAC prominence: for example, Sky argues that DSAC should not have a central role,[61] and that settling upon FAC would be the appropriate course.[62]

65. It is wrong to suggest that DSAC is completely divorced from economic justifications. On the contrary, the increased flexibility provided by applying DSAC rather than FAC is supported by economic justifications. BT's criticism of DSAC is that it does not go far enough to give effect to the underlying economic considerations justifying price flexibility.

66. There is some common ground between BT and TalkTalk to the extent that both agree that DSAC may or may not alight on the right amount of flexibility "*by chance*".[63] The difference however is that TalkTalk is concerned that DSAC gives too much flexibility. BT's concern is the opposite one; namely, that it gives too little flexibility. It is valid to note that precisely the same criticism of "arbitrariness" applies to the first two limbs of the three-fold test espoused

[59] TalkTalk's Response at § 3.33.
[60] TalkTalk's Response at § 3.35.
[61] Sky's Response at §7.
[62] Sky's Response at §9. See also Verizon's Response, Virgin Media's Response at §5.2 and CWW at §38.
[63] Ibid, §3.35.

by TalkTalk. In other words picking a percentage above FAC and applying it is just as "arbitrary", and provides no certainty that the correct degree of pricing flexibility has been made available, or that the various competing economic interests have been correctly reflected. It is difficult to see on what basis the figures of 10% or 30% have been selected, or are justified.

67. Indeed TalkTalk's approach seems to assume that a price set at DSAC is the absolute maximum limit for a cost orientated price and that therefore a test set at lower level is necessary to give a true indication of cost orientation. To the contrary, a price set above DSAC can clearly still be cost orientated. This was expressly recognised by the CAT when considering the suitability of DSAC[64].

68. The Disputing CPs advocating FAC (or something similar) are wrong to suggest that there are no economic justifications for a significant level of pricing flexibility. They either ignore or relegate the importance of dynamic efficiency and the interests of those developing and supplying wholesale services. It goes without saying that innovation and investment are to be encouraged. BT commented in § 399 of its 20 April Response on the fact that Ofcom's objectives are not limited to achieving allocative efficiency but also include, amongst other things, ensuring dynamic efficiency. As BT noted there:

> "*Imposing price ceilings close to costs has a negative impact on dynamic efficiency as it reduces incentives to invest where returns are uncertain ex ante.*"

69. Hand in hand with this is the equally strong interest in encouraging market entry, which once again the Disputing CPs overlook or downplay. TalkTalk is very careful to refer to "*efficient entry*" (see heading 3.1.4) and it discusses the theory underlying the use of "*forward looking economic costs*" in § 3.43 of its Response and the paragraphs which follow it. However, it is important to bear in mind that in practice allowing greater pricing flexibility and higher prices (as opposed to requiring prices below BT's FAC, see TalkTalk § 3.49, suggesting that these are "*efficient forward looking economic costs*") is likely to encourage market entry. The Ethernet market was a new market. There was a clear economic justification throughout the relevant period for allowing higher prices which encouraged additional competition for BT from other firms in the wholesale market, thus benefitting consumers in the longer term.

70. As BT noted in §§ 71 and 72 of its 20 April Response, Ofcom was keen for there to be a sufficient margin on BT's Ethernet products so as to enable backhaul competition to be able to

[64] See §285 [2011] CAT 5.

flourish and to encourage unbundling, rather than a close correlation between prices and costs which would have deterred market entry: see also § 338 of that Response explaining the developments which the development and launch of Ethernet products had made possible, including in § 338.1.2:

> "*the expansion of backhaul networks, especially by C & W and Virgin Media, using short access circuits for infill on their networks and so stimulating competition in the wholesale market;*"

71. TalkTalk's suggestions are all premised on the notion that charges should be set to maximise static efficiency (where prices are in line with costs). They pay no regard to dynamic efficiency and the benefits that result from sustainable competition in the longer run. Prices above FAC can be 'efficient' if they are consistent with the development of competition that would not otherwise be possible because the benefits of competition in the longer run outweigh any short term loss of static efficiency.

72. Ofcom has also recognised on many occasions that BT enjoys scale and scope economies that are not available to its competitors, meaning that competitors (even when they are efficient for the scale they are able to achieve) can find it hard to match BT's FAC. This means that prices above FAC are needed for competition to develop to its full potential[65].

73. The point about dynamic efficiency in new markets is especially important in the present case. Ofcom clearly wanted to see whether competition would develop and had not formed a view

[65] Indeed, just months before publishing *Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets: Final Statement and Notification,* which imposed cost orientation on AISBO services, Ofcom published its Determination of Final Explanatory Statement and Notification to its *Review of the Wholesale Broadband Access (WBA) Markets:*
http://stakeholders.ofcom.org.uk/binaries/consultations/wbamp/summary/broadbandaccessreview.pdf
This document considered what price obligations to impose following a finding of SMP under the CRF. Ofcom set out there why it did not intend to impose LRIC plus a mark-up for fixed and common costs (i.e. a control analogous to FAC). The circumstances in which Ofcom decided not to set LRIC plus (or FAC) closely match those which also applied to AISBO services. Ofcom explained in its WBA Final Explanatory Statement and Notification that:
"Ofcom considers that, even though these markets are not effectively competitive at the moment, there is uncertainty as to future market developments, i.e. beyond the period of time considered in the review. In a situation where market power is not entrenched, cost based regulation appears disproportionate and may even deter the development of greater competition" (§4.47)
"Ofcom believes that, since these are still immature markets, setting cost-based charges would be a risky exercise which may lead to charges that do not provide the correct economic signal to entrants. In immature markets there is a high degree of uncertainty with regards to costs, and issues such as the timing of cost recovery and the appropriate rate of return on the capital employed are more complicated than in established markets…. Accordingly, Ofcom considers that regulating charges on a cost-plus (i.e. LRIC plus) basis would be premature and potentially harmful to investment decisions and that, given the specific nature of the markets, retail minus appears to be the most appropriate pricing rule." (§4.48)
In other words, LRIC plus (or FAC) was rejected because the markets were still immature and there was uncertainty as to future market developments. Both of these features applied to Ethernet services over the period of the disputes, illustrating why it would have been wrong to impose a charge control (aimed at FAC-based charges for 2005 to 2009) and why it would be wrong to, in effect, now impose such a control retrospectively.

as to whether a price control was necessary, as explained in the July 2004 LLMR statement, which said:

> *"7.63 Ofcom is of the view that it is not currently necessary to impose a price control on AISBO products. The AISBO market is in a relatively early stage of development and it is necessary to give time for the effects of the cost orientation obligation to impact on the competitiveness of the market before considering whether a price control is necessary. The need for a price control will be considered when the market is next reviewed."*
>
> [emphasis added]

74. Frontier overlooks these interests in its discussion of efficiency, where it lists various possible distortions arising from prices which exceed FAC (at paragraph 52), but omits to mention the possible dynamic benefits of greater infrastructure-based competition. This significant and inexplicable omission leads it to conclude that, from an efficiency standpoint, a FAC price ceiling is better than one based on DSAC (§ 68 of its report). However this conclusion is not correct.

75. In addition it should be noted that prices in excess of FAC across the whole AISBO market (not just on individual products) are capable of being justified on the basis of dynamic efficiency considerations.

76. If Ofcom were now to apply a FAC test, or to apply either of the first two limbs of the TalkTalk proposal (that is, FAC plus some percentage), that would effectively be imposing an RPI-X price control on the product group in question but *after the event*. That would be an unsatisfactory response for many reasons. First, it would effectively be going back and altering the deliberate decision which Ofcom made in 2004 when it decided not to impose a charge control on AISBO services in 2005 so as to avoid setting charges in line with FAC. That decision was made for good economic reasons (discussed above), and it would be both incorrect, and contrary to principle to alter it now with retroactive effect.

77. Secondly, none of the advantages which TalkTalk and Sky identify in terms of economic efficiency can be obtained by setting a different cost standard retrospectively. Even if for the sake of argument their approach was the correct one, it needed to be imposed at the time in order to give rise to the efficiency benefits that they describe, and not many years after the event. Again this shows that TalkTalk's suggestions (whether they have merit or not) can only be relevant to Ofcom's forthcoming consultation on cost orientation and should not be applied retrospectively.

It is not for BT to demonstrate that supposed conditions for the use of DSAC have been met

78. A second argument put forward by TalkTalk and Sky is that it is for BT to make out the case for the application of DSAC, by for example establishing the price elasticities of the retail products for which the various Ethernet products provide the infrastructure, and comparing this with the price elasticities of other products sharing common costs.[66] They also refer to the need to show no overall over-recovery (which is discussed below).

79. There is, however, no basis for arguing that the application of DSAC is subject to satisfying various stringent evidential conditions. In truth, this is simply another way of arguing that FAC should be applied as the norm, unless conditions which are difficult to make out can be established. For the reasons given above, FAC is not the appropriate cost standard to be used in relation to the cost orientation obligation many years after the event. Ofcom has never previously suggested that the use of DSAC (which is justified quite separately from the issues of relative price inelasticity) is conditional on various evidential matters being established. To impose such conditions retrospectively would be contrary to the principles of legal certainty and non-retroactivity. Ofcom should reject the suggestions put forward by Sky and the TalkTalk Group in this regard.

There is no over-recovery problem

80. Sky and TalkTalk both suggest that there is a problem of potential over-recovery if all related products are priced at DSAC, and that the onus is upon BT to show that there has been no over-recovery if it wishes to benefit from the application of the DSAC test (as opposed to FAC or some other test with less pricing flexibility). TalkTalk also proposes a specific limb of its three-fold cost orientation test which it refers to as "an overall cost-recovery test", which it says gives rise to a repayment of £205m and which is its preferred approach.[67]

81. First, Ofcom should acknowledge that Openreach has not "over-recovered costs" because DSAC has been used as a price ceiling. Excluding the effect of Holding Gains and Losses, the rate of return on Openreach SMP services (including AISBO) assessed on a CCA basis was almost exactly in line with the cost of capital over the period from 2006-07 (the first year for

[66] See e.g. Sky Response §§55-57 and TalkTalk Response §§3.79-83.

[67] That being so, it is not clear what purpose the two other aspects of its "cumulative" test serves, or whether in truth they are alternatives rather than cumulative conditions.

which Openreach returns are available) and 2010-11[68]. The fact is that whilst there has been flexibility under SMP obligations, this has not enabled BT to "over recover" its costs in total. This is particularly relevant given the extent of costs which are shared across services subject to FAC-based regulation (under RPI-X charge controls) and subject to cost orientation.

82. Secondly, there is no requirement to this effect under the European Directives or the 2003 Act. Such a test would, in effect, mean that price regulation was solely about ensuring cost recovery. This was rejected as a form of regulation in the early 1980s.

83. Thirdly, Ofcom has never suggested that such a test is to be applied. Ofcom considered it appropriate to set regulation such that prices covered FAC across the set of relevant services of services identified by TalkTalk, then it would have imposed such regulation at the time. Further, BT is unaware that Ofcom has ever imposed rate of return regulation in the way effectively suggested by TalkTalk with the third limb of its proposed approach. It would be quite wrong to make such a policy shift under a dispute resolution process for all of the reasons relating to legal certainty and non-retroactivity already outlined above.

84. Fourthly, to BT's knowledge, no system of regulation has imposed, many years after the event, the stricture that charges be set on the basis of "efficient costs". Much of the CPs arguments for justifying a test based on FAC or FAC plus a percentage seems to revolve around presupposing economically efficient costs. TalkTalk at §3.43 of its Response states "*Entry/investment will be most efficient if prices are set at the 'efficient forward looking' costs*" [original emphasis]. TalkTalk uses this phrase *"efficient forward looking' costs"* in a number of other places to justify its arguments, for example, stating at §3.50 of its Response "*Competition in downstream markets will be least distorted and most effective if prices are set at efficient forward looking costs and so below BT's actual FAC*" [emphasis added]. Even if BT's revenues had exceeded FAC across a broad range of products, that might well be consistent with dynamic efficiency requirements, and with the outcome that ordinarily might be seen in fully competitive markets.

85. However, this ignores the core point that the cost orientation obligation did not specify that prices had to be "*reasonably derived from the efficient costs of provision based on a forward looking long run incremental cost approach*". BT was simply required to ensure prices were "*reasonably derived from the costs of provision on a forward looking ....cost approach"* i.e. the costs that BT had incurred (albeit primarily on a CCA, rather than an historic, cost approach).

[68] This is before Ofcom's proposed repayments in the Draft Determination.

That of course is reflected in the RFS using BT's actual cost figures rather than the costs of a notionally efficient operator.

86. Accordingly, an underlying premise of TalkTalk's argument as to economic efficiency, namely that the obligation must be assessed by reference to efficient forward looking costs (for which, it is argued, FAC provides a much better solution than DSAC), runs contrary to the actual wording of the obligation imposed on BT. It runs contrary to all tenets of legal certainty and transparency to interpret the cost orientation obligation in a manner that imports a requirement on BT to demonstrate "*prices are set at efficient forward looking costs*" rather than what the wording actually states.

87. Fifthly, even TalkTalk Group recognises that such a test has the difficulty that it requires the identification of the set of relevant services *outside* those in dispute (and outside the relevant market) and the comparison of those revenues to FAC. This opens up a new area of enquiry which is outside the scope of the Disputes.

Matters outside the scope of the Disputes

88. It should be noted that some of the Disputing CPs continue to introduce material and allegations that have never formed part of the dispute to support their contention that Ofcom should use some variation of FAC rather than DSAC to judge cost orientation, showing their determination to leave no stone unturned in relation to their arguments on this point. For example, TalkTalk now assert that:

> "*Prices above efficient forward looking costs will mean BT's downstream rivals experience higher costs than BT's own vertically integrated) retail activities thus creating margin squeeze...*" § 3.50
>
> *"... BT's downstream operations 'pay' is merely notional since there is no real cash transaction/ flow and BT is likely to price its retail services based on costs and not internal prices*" End note v. to § 3.50
>
> "*If the compliance test aggregates internal and external services then it would in effect allow BT to cross subsidise from external services and so distort competition. This is what BT have actually done*" §7.7

89. These are new specific allegations that BT has discriminated (as it made explicit at §7.8 of TalkTalk's Response). Such discrimination would not only be contrary to BT's SMP conditions, but also plainly breach the Equivalence of Inputs obligations. These allegations have never

formed part of this dispute. There is absolutely no reference to any allegation of discrimination or them in Sky and Talk Talk's original submission dated 27 July 2010. They are not included in Ofcom's scope of the dispute. BT's strongly objects to these allegations, allegations which are completely wrong. It would be wholly wrong for Ofcom to take any account of material based on these allegations.

Conclusions

90. The attempts of the CPs to argue for FAC, FAC plus a particular percentage, and an overall cost-recovery test should all be rejected. It would be wholly inappropriate for Ofcom to go back on the generally understood standard for assessing cost compliance and to seek to apply, retrospectively, a test other than DSAC in order to impose a liability on BT of many millions of pounds.

HOLDING GAINS

91. In assessing the unit DSAC for the year 2009-10, Ofcom has followed the approach taken in the RFS and in assessing costs has excluded the exceptional holding gain in that year. TalkTalk, CWW and Virgin all take issue with Ofcom's approach.

TalkTalk Group

92. TalkTalk suggests that it is inconsistent to exclude the holding gain but to reflect the higher depreciation and capital employed charges and puts forward three other possible approaches[69]:

> *"Recognising the need for a consistent approach, we consider there are three options for the treatment of this:*
>
> > *First the revaluation can be ignored meaning that there will be no holding gain and no increase in future capital costs which will avoid any potential inconsistencies*
> >
> > *Second, the revaluation could be included but the holding gain spread forward. Applying it in this fashion, however, would risk negating the effect of the revaluation completely. If the new approach is a better representation of replacement cost on a*

[69] TalkTalk Response § 5.27

future looking basis, applying the holding gain in this way would remove the benefit of having a more accurate valuation methodology.

Third, the revaluation could be included but the holding gain spread backward to the years before 09/10. This will reflect the gradual change in the environment for laying duct and this 'smoothing' effect on costs will reflect the actuality of the theory behind the accounting change."

93. The approach that Ofcom has adopted is the best available and none of the three other approaches listed above would be appropriate.

Ignore the Revaluation

94. To ignore the holding gain entirely would be, in effect, introduce an element of historic cost accounting ("HCA"), because changes in value over time would not be fully taken into account. This would not be appropriate. The use of current cost accounting, rather than HCA (or elements of it), for regulatory purposes is well established and has not been disputed by TalkTalk or any of the other Disputing CPs.

Spread Holding Gains Forward

95. The effect of spreading the gain forward would also introduce an element of HCA as the supplementary depreciation and return on capital employed in future years would be offset by the share of the holding gain attributed to that year.

Spread Holding Gains Backwards

96. This approach would mean that the costs used to assess cost orientation would be lower than the costs of which BT was aware when it set the prices and it would clearly be unreasonable to suppose that BT could say have forecast in 2006 what holding gain would arise in 2010.

Cable&Wireless Worldwide

97. CWW suggests that:

"*The starting position must be that the holding gain is an essential part of the CCA methodology and should be applied in the year that the asset revaluation took place unless strong evidence is available to support the exclusion of some of it."* [70]

[70] CWW Response §114

98. This is wrong. As noted in the RFS:

> "*Whilst this large holding gain has been recognised in 2009/10 it does not represent a genuine periodic change in the valuation of the duct assets. BT believes that it results in an artificial upwards distortion of returns in the year. BT has agreed with Ofcom that: alternative information will also be supplied – …[to] also show a calculation of the return excluding the duct holding gain and related backlog depreciation to provide a more meaningful view of the underlying rate of return."* [71]

TalkTalk

99. TalkTalk agrees with Ofcom and BT that including the holding gain in a single year would not be appropriate:

> *"Clearly, if the resulting holding gain is allocated across a single year (2009/10), this would result in a significant change (reduction) to the costs in the RFS. This may be undesirable as BT would be facing a large reduction in costs which, arguably, it may have been unaware of when setting prices."*[72]

100. Indeed we note that TTG has suggested that this should be a general rule:

> *"The [RFS] figures should also be presented without holding gains which create "noise and make the numbers less meaningful"*[73].

101. Finally Virgin called for the assessment of holding gains to be based on the RFS:

> *"Virgin Media believes that a consistent approach to that used in the PPC Judgment should be applied to holding gains/losses in this dispute … This means that the treatment of holding gains/losses should be based upon the "actual holding gains and losses as reported by BT in its regulatory financial statements"*[74]

102. BT agrees that the holding gains and losses reported in the RFS should be used, but note that in this case it should be the "alternative" view of holding gains agreed with Ofcom and published in the RFS that is the appropriate one.

[71] RFS 2009-10 page 18
[72] TalkTalk Response§5.26
[73] TTG response to "Ofcom review of cost orientation and regulatory reporting in telecoms paragraph 29)
[74] Virgin Media response to Ethernet determinations paragraph 8.1.1

PROPORTIONATE OR ABSOLUTE ADJUSTMENTS TO DSAC

103. In its report annexed to the responses from TalkTalk and Sky, RGL states that:

> *"…the appropriate range for the DSAC adjustment is between a minimum of the absolute adjustment to FAC and a maximum of the proportionate adjustment to FAC. Further analysis should be conducted by Ofcom to determine the appropriate mix of adjustment to use"* [75]

104. BT agrees with RGL. We also agree that "*the mix differs for each adjustment*"[76]. The output of BT's LRIC gives the proportion and category of fixed and common costs attributed to each relevant cost component and category and this would allow an appropriate assessment of the appropriate mix of adjustment to use in each case. We would be happy to supply the necessary information to Ofcom to assist with this assessment.

105. RGL's numeric assessment in its paper[77] uses a proportionate approach in all cases and bases this on a DSAC:FAC ratio that is an average, not specific to the cost components. As RGL recognises such an approach is illustrative only as "RGL does not have access to BT's LRIC model"[78] and not an appropriate one. BT could supply Ofcom with component specific information that would allow a more appropriate assessment to be made.

RAV ADJUSTMENT

106. RGL on behalf of TalkTalk and Sky suggest that the Regulatory Asset Value (RAV) adjustment should be applied to the Ethernet costs[79].

107. Such an adjustment would be different in kind from the adjustments made by Ofcom (and proposed by BT). The adjustments made by Ofcom and proposed by BT correct errors in the reported RFS and/or align the costs with those used by Ofcom in its modelling for the purposes of the 2009 LLCC. The intention is to produce a corrected set of costs that is

[75] Paragraph 5.4.01 to Annex 3 to the Sky response to the draft and provisional Ethernet determinations
[76] Ibid paragraph 5.03.5.
[77] Ibid paragraph 5.03.06
[78] Ibid § 5.03.04
[79] RGL Report § 4.05

consistent with the basis on which past regulatory decisions were made and which could have guided BT's pricing decisions.

108. The inclusion of the RAV adjustment would have a quite different effect in that it would significantly change the basis on which Ethernet costs are calculated. When calculating Ethernet costs BT was entitled to rely on and adopt the approach taken by Ofcom in the 2009 LLCC. For the very good reasons particularised by Ofcom at, for example, §§ 5.59 and 5.60 of the LLCC Statement, Ofcom correctly decided not to make the RAV adjustment when it assessed cost for the purpose of the AISBO market charge controls. There is no way in which BT, when setting Ethernet charges could have predicted that the basis on which costs would be calculated, for the purposes of assessing cost orientation, would be different to or in the future change by the inclusion of the RAV adjustment. It would therefore be unfair and illogical to assess cost orientation on the basis that the RAV adjustment should have been included.

109. If, contrary to the approach that Ofcom has adopted in the 2009 LLCC, Ofcom considers that it may be appropriate to reconsider its approach to RAV this is not something which should apply retrospectively. To do so would be unfair to BT.

110. RGL's argument for the inclusion of the RAV adjustment seems to be simply that Ofcom erred by not applying the RAV adjustment in 2009 and they contend that Ofcom's assumption that Ethernet services used relatively low levels of pre-1997 duct (and no copper) was misguided. Further, RGL misrepresent Ofcom's reasons for not applying the RAV adjustment, prominent amongst which reasons was the desire to promote infrastructure based competition. The RAV adjustment would have distorted prices downwards and might have discouraged such competition. However:

    a. none of the Disputing CPs appealed the LLCC on the basis that the RAV adjustment should have been reflected in the charge control;

    b. equally, had the RAV adjustment been included then BT would have had the opportunity to appeal this aspect of the charge control but this opportunity has now passed; and

    c. as set out above, BT is entitled to rely on decisions made by Ofcom and to anticipate that its decisions will not subsequently be changed for the purposes of resolving a dispute and applied with retrospective effect.

NASCENT MARKET AND INTERACTIONS WITH OFCOM

111. The issues raised by the Disputing CPs in respect of the nascent nature of the market and BT's interaction with Ofcom, are already addressed in detail in BT's 20 April Response.

Nascent Market

112. BT's arguments in section 3 of its 20 April Response illustrates the context in which BT was taking its pricing decisions and demonstrate the difficulties it faced with *ex ante* compliance[80]. These factors do not absolve BT from complying with Condition HH3.1, but rather that they provide a context that demonstrates that Ofcom's proposed approach is mechanistic and harsh. At the very least, these factors mean that Ofcom should accept either that BT was not in breach of Condition HH3.1, or that it would be unfair or unreasonable to direct BT to repay any charges over DSAC for the period 2005-2007[81].

113. With respect to the difficulty of judging anticipated take up volumes, the disputing CPs point to the pre-existing retail product and to the forecasts provided to BT by its customers. For the reasons explained in § 3.3.1 of BT's 20 April Response, notwithstanding the fact of a pre-existing retail product, BT lacked a settled track record of cost-volume relationships and likely and forecasts, including those provided by the Disputing CPs, underestimated demand. Indeed, the changes to the forecasting process highlighted by CWW in Annex 1 to their response were the result of serious on-going problems with CP forecasts[82], including forecasts from the Disputing CPs.

Interaction with Ofcom:

114. BT's comments in section 2.2 of its 20 April Response serve to highlight the context of uncertainty and lack of transparency in which it sought to comply with Condition HH3.1. BT's references to the close contact and numerous meetings it held with Ofcom throughout the relevant period should be understood in this context, and not viewed as <u>exclusively</u> legitimate expectation arguments. The very rigid parameters of the DSAC test Ofcom now seeks to apply

[80] A problem recognised by the CAT in its PPC Judgment, see § 77of BT's 20 April Response.
[81] See §§ 76 to 79 of BT's 20 April Response.
[82] As can be seen from the slides presented at the Ethernet Customer Forums held in February and March 2007 (i.e. at the time of the contractual changes referred to in Annex 1 of the CWW response to the Draft Determinations), BT faced significant difficulties with its resource planning, equipment supply, service provision and ultimately pricing due to the patchy and unreliable forecasts it received from CPs. This was in part due to CP concerns about the operation of the SLG non-payment penalty, which was deterring them from providing regular, accurate or committed forecasts. The contractual changes proposed by BT sought to alleviate these CP concerns and thus to improve the provision and accuracy of forecasts.

were never appreciated by BT[83] - or, as is clear from their responses, by the disputing CPs - nor explained to it contemporaneously by Ofcom, even though Ofcom had ample opportunity to make its approach clear[84]. In this context, BT considers that Ofcom would be acting contrary to its duties as regulator to act in a transparent, consistent and proportionate manner if it pursued its proposed approach.

BES 10000

115. In Annex 1 of its Response, Sky refers to BES 10000. In §7.16 of the Draft Determination, Ofcom correctly identified the highly cursory and obscure references to BES 10000 in the Dispute Submission filed on behalf of Sky and TalkTalk dated 27 July 2010. For example there is no analysis of BES 10000 in section 5 of RGL's report dated 23 July 2010 dealing with repayments. If Sky was making the (serious) allegation that BT was in breach of the basis of charges condition applicable to BES 10000 despite this, then this should have been made crystal clear.

116. The dispute resolution process is not to be used by CPs on the basis that they can throw everything up in the air and expect Ofcom to find and collate material to try and work out what is in dispute. Not only is it unfair to expect Ofcom to do that, but it is grossly and procedurally unfair to BT. For example, proper negotiation is supposed to have taken place before Ofcom accepts a dispute and it should be clear to all parties what the dispute is about.

117. BT cannot comment on the material supplied to Ofcom before the Draft Determination but additional to the dispute reference shared with BT, since it has been treated as confidential and BT has not had sight of it. However, even from the material in Annex 1 of Sky's response it is quite clear that Sky is now seeking to rely on wholly new material. For example "*Sky has recently trawled its invoicing records and has located various invoices*".[85] It then suggests that Ofcom should review this "*...and if necessary request BT to provide it with information to verify the amount it received from Sky...*". This is a completely improper way of approaching the Dispute Resolution process, this material should have been provided by Sky at the time that it submitted its dispute reference.

[83] See in particular, BT's review of the limited Ofcom (and previously Oftel) guidance available on how BT should approach cost orientation in the Ethernet market at sections 3.4.2 to 3.4.8 of its response of 20 April 2012.
[84] See in particular, paragraphs 20-22 of BT's response of 20 April 2012.
[85] Neither Ofcom nor Sky have provided BT with a copy of Annex 4 of its Response containing these invoices

118. Article 20 of the Framework Directive (in amended or unamended form) makes clear that disputes should be resolved "*in the shortest possible timeframe*" and in any case within four months. This dispute will already have taken nearly two years to resolve. BT does not necessarily seek to criticise Ofcom for this[86], though it vehemently rejects the suggestion that BT has deliberately dragged the process out[87]. However for Sky now to introduce new material to support a claim never properly previously made is wholly wrong and inconsistent with the whole Dispute Resolution process. Ofcom was absolutely right in the conclusions it reaches in §§ 7.16 and 7.17 of the Draft Determination and these conclusions should be maintained.

119. That all said, for the purposes of the products in dispute in these Disputes only, and for reasons of pragmatism and to avoid the difficulties already caused by multiple disputes covering the same issues, BT is content, subject to the Disputing CPs agreeing[88] to repay BT should any subsequent CAT or Court Judgment have the effect of setting aside or nullifying Ofcom's Final Determinations, to treat any of the Disputing CPs' additional claims, in the same way as the services in dispute are determined.

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[86] Though this is without prejudice to BT's appeal that the dispute resolution process is not the correct process for this type of investigation.

[87] Made for example by TalkTalk at §4.45 in its Response. BT has been responding to enormous claims from the CPs and must be given the opportunity to deal with them if the dispute resolution process is to be used as an alternative process for compliance investigation. But in any event BT has not dragged the process out. A two week extension for its Response in the circumstances given the material BT has wanted to submit is hardly deliberately obfuscating.

[88] And of course BT and the individual disputing CP agreeing the terms of a settlement agreement.