



OFCOM

Ethernet dispute draft determination

TalkTalk Group submission

RESPONSE TO BT RESPONSE

Non-confidential version

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1 Introduction and summary

- 1.1 This is TalkTalk Group's ('TalkTalk') response to BT's response to Ofcom's Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT's charges for Ethernet services dated 9 February 2012.
- 1.2 We welcome the opportunity to respond to BT's response. TalkTalk received BT's response on 4 May and we were given only 2 weeks to respond. Thus this response represents what we were reasonably able to complete in the two-week period available.
- 1.3 BT response is very long (148 pages), rather repetitive, unclear and includes many points that are spurious (or at least have unexplained relevance). Further, it is sometimes hard to disentangle the various arguments that BT is seeking to make (particularly since it contradicts itself in places). This suggests that either BT lacks any sound and reasoned case and/or it is attempting to confuse and muddy the waters. Notwithstanding, our key points in response to BT's submission are summarised below.
- 1.4 BT complain repeatedly that it was not aware of and/or **Ofcom had not made clear what BT's cost orientation obligations entailed**. This is plainly a fallacious claim:
 - 1.4.1 BT has previously stated that it was compliant with its obligations (which could only have been the case if it understood its obligation)
 - 1.4.2 The obligation is manifestly laid out in HH3 and the 1997/2001 Guidelines. That the obligation was not highly precise is not unusual (compared to other regulations) and anyway lack of precision is something that BT itself pushed for to allow it flexibility
- 1.5 BT's claims regarding clarity reveal a fatal misunderstanding of its obligations and/or a cavalier disregard of them:
 - 1.5.1 BT argue that it was Ofcom's responsibility to 'make clear' the obligations or let BT know if it was non-compliant. This is wholly at odds with the actual regulation which is squarely an obligation on BT (which it cannot assign to someone else) and moreover includes a positive duty on BT to demonstrate compliance
 - 1.5.2 BT also seem to suggest that the fact that there was lots else happening (e.g. equivalence, re-organisation, product development, market growth) justifies a weakening of its obligations. This reveals either a misunderstanding of the obligation or a cavalier attitude to compliance
 - 1.5.3 BT has displayed a woeful and negligent lack of action to understand and robustly manage compliance with the obligation. Even though these obligations have been in place for 15 years, BT seemingly took no steps to: properly understand the obligation; ensure that it had the necessary reliable

cost data; and, develop and implement an ongoing compliance process to check prices and expeditiously adjust prices

- 1.5.4 Given the (now claimed) lack of clarity and its lack of active compliance management the natural thing that BT should have done was 'err on the safe side' by pricing close to FAC. Instead BT chose to gamble and it opted to set prices up to 3½ times FAC.
- 1.6 In light of this context, Ofcom must certainly not do what BT is suggesting which is to cut it some slack and go soft on it. Such an approach would reward negligence and abuse. Rather Ofcom should be tougher on BT. Further, Ofcom should consider opening a compliance investigation on BT, not just covering its excessive pricing but also its failure to comply with cost accounting obligations and its failure to meet its obligation to demonstrate that its prices were cost orientated.
- 1.7 BT has accepted that its previous stance on aggregation was untenable. They continue to maintain that that **rental and connection should be aggregated**. We consider that this is clearly mistaken: HH3 clearly states that 'each and every charge' should be cost orientated and rental and connection are plainly different charges; misalignment of connection and rental with costs can result in competitive and investment distortions; and, the separate reporting of rental and connection in the RFS supports a disaggregated approach.
- 1.8 BT seeks to argue that **several years of excessive pricing should be required** to find non-compliance. However, there is nothing in the wording of HH3 or the 1997/2001 Guidelines that supports this interpretation.
- 1.9 BT plead that it is was difficult to comply with its obligations since there was 'so **much uncertainty about costs**'. On proper inspection this is a baseless assertion that is not supported by the particular circumstances of WES/BES.
 - 1.9.1 The cost of individual components (and CVRs) were well understood since the components (e.g. duct, fibre, Ethernet electronics, support) were mostly assets and activities that BT have been using for years. Though WES/BES was a new product its underlying components were mostly highly mature
 - 1.9.2 Given the nature of most of the costs (either variable or fixed and shared), the unit costs were not highly sensitive to unpredicted demand
 - 1.9.3 BT did not have to, as it suggests, wait until the RFS were published to find out its actual costs. It could and should have been able to estimate FAC/DSAC costs on a monthly basis
- 1.10 Regarding BT's submission on **adjustment to the DSAC costs** we have the following comments:
 - 1.10.1 Contrary to BT's arguments 21CN costs should be excluded since they are plainly not required to provide WES/BES services but are for different services. That they are (BT claims) 'closely related' and that WES/BES customers might buy them in the future is beside the point and provides no sound reason to include their costs in WES/BES.

- 1.10.2 BT's proposed approach to payment terms would mean customers paying twice for late payment – once through late payment charges and secondly through higher WES/BES prices.
- 1.10.3 BT's proposed increased DSAC costs due to adjustments for BES fibre, provisioning, ISDN monitoring and the new 'split cost' method must be squarely rejected by Ofcom . Unlike the adjustments that Ofcom made (some of which are in BT's favour) these adjustments:
 - 1.10.3.1 are not hard-edged mathematical errors
 - 1.10.3.2 all involve reallocation and so reduced costs elsewhere (but BT is not proposing to reduce costs/prices elsewhere as a result)
 - 1.10.3.3 introduce bias, lack of transparency/scrutiny and will create an incentive for BT to have error strewn accounts since BT can selectively discover 'errors' in its accounts that will have no audit scrutiny. (It is no coincidence that BT found no errors in CPs favour). This is inequitable and asymmetrical since CPs cannot seek errors.
 - 1.10.3.4 Further, all these should be rejected since they are not clearly reasoned or evidenced and the 'split cost' method is, according to RGL, simply another method that appears no better or worse than then current one.
- 1.11 BT introduce a vague argument about the need to apply **the 'counter-restitution' principle** in deciding the repayment. This principle has no role in this case since s190 which governs repayments is absolutely clear about the approach to repayment and BT's case appears to be premised on reading-in to the Communications Act some rules from other areas of law that are not relevant.
- 1.12 The submission is structured as follows:
 - 1.12.1 Clarity of obligations (section 2) assesses how clear BT's obligations were and what the appropriate approach by BT should have been in the circumstances
 - 1.12.2 Approach to applying ceiling (section 3) discusses a number of aspects of how the ceiling should be derived and applied
 - 1.12.3 Aggregation of rental and connections (section 4) examines whether it is appropriate to test cost orientation test on rental and connection together
 - 1.12.4 Cost predictability (section 5) assesses whether BT's cost were unpredictable
 - 1.12.5 DSAC cost adjustments (section 6) discusses BT's suggested changes to Ofcom's proposed cost adjustments
 - 1.12.6 Other issues (section 7) picks up a other areas that BT raised in its submission
- 1.13 We would be very happy to provide Ofcom additional information to help in its consideration of this dispute.
- 1.14 All references are to BT's submission unless otherwise stated.

2 Clarity of obligations

2.1 Much of BT's submission tries to paint a picture that BT simply did not know what approach Ofcom would take to assessing cost orientation. For example:

Ofcom's approach was not made clear to BT [§ES36]

During the relevant period BT was not aware of the obligations that would be imposed upon it ... (§17)

2.2 In this section we discuss the clarity of the obligation and also, in the case of any lack of clarity, what BT's response reasonably could and indeed should have been¹.

2.3 This section is laid out as follows:

2.3.1 First we discuss a number of contextual matters and in particular how BT's argument that its obligations were unclear is patently inconsistent with their previously stated position

2.3.2 Second we discuss whether the cost orientation was in fact unclear

2.3.3 Third we discuss the steps that BT could have and should have taken to ensure compliance (but as we show it did not take)

2.1 BT has changed its position

2.4 Before addressing the question of whether BT had clarity there are a number of contextual matters that are worth noting.

2.5 First, BT's argument that the cost orientation obligation is unclear is novel and seems to have been invented by BT as a tactic to try to defend itself in this dispute. In particular, during the discussions Sky and TalkTalk had with BT, BT said:

First of all, it is perhaps appropriate to stress that we fully appreciate our obligations for Ethernet charging, namely that our pricing is governed by a general cost orientation obligation, rather than any specific pricing controls. In support of this (and as you know well) we submit annual regulatory accounts that are closely scrutinised by not only by Ofcom but also by external auditors. We maintain our view that our pricing of Ethernet services has been in accordance with all applicable regulatory and Undertakings requirements.²

¹ BT also raise the related, but legally separate, issue of whether Ofcom has met its duty of transparency in relation to making clear what BT's obligations were. This issue raises similar matters to the question of clarity of BT's obligations but it is a separate issue (not least since it pertains to Ofcom's duties rather than BT obligations). We deal with this question in Section XXX below.

² Letter Anne Heal to Andrew Heaney 18 July 2008

- 2.6 This statement does not display any uncertainty on BT's part as to what its regulatory obligations were. Stating that it was compliant with its obligations is wholly at odds with its claims in its response that the obligations were not clear³.
- 2.7 Second, it was BT who pushed for 'flexible' and light touch controls on its wholesale prices rather than more rigid constraint such as would be required under charge controls. Thus it is quite astonishing for BT to now complain that the cost orientation obligation is unclear when it itself pushed for such a situation. BT has never, as far as we are aware, argued for charge controls to be applied instead of (or as well as) a cost orientation obligation in order to make BT's obligation more precise. Rather, BT has consistently argued against the imposition of charge controls saying that it needed the flexibility⁴.
- 2.8 BT's support of cost orientation (instead of charge controls) and that it did not previously consider the obligation unclear is further reinforced by several additional facts:
- 2.8.1 BT has never as far as we are aware argued in market reviews when cost orientation obligations were being imposed indicated that the obligation was unclear
- 2.8.2 if BT had thought that the cost orientation obligation was unclear it could have asked for a charge control to be applied but it never did so
- 2.8.3 even in the case where BT argued that no cost orientation obligation should apply to a particular service it never used as a reason for its stance that a cost orientation obligation was unclear
- 2.9 Third though BT claims that it was all terribly unclear, BT has not, as far as we are aware, provided any evidence of what it actually thought at the time about how the cost orientation obligation might be interpreted by Ofcom (e.g. was it DSAC, was it less than DSAC etc) or how they came to their decision about how to set prices. Similarly, there is no documentary evidence to show that BT thought it was unclear.
- 2.10 Thus BT's now claims that the cost orientation obligation was unclear is an all too convenient invention. The available evidence suggests that they were comfortable with the obligation and confident that they complied.
- 2.11 Perhaps a plausible explanation of BT's contradictory and inconsistent behaviour is that they had decided to ignore their cost orientation obligation or took a brazen and cavalier attitude to compliance thinking that Ofcom would interpret the obligation in a way that would allow BT lots of leeway. Prices were set principally based on what BT thought the market would bear or BT could 'get away with'.
- 2.12 In any case, the arguments they are now advancing are little more than *ex post facto* reasoning and should be dismissed as such. Bt must explain what it actually did and

³ In the PPC Appeal, Mr Morden a BT pricing manager was asked "has never been any doubt in BT's mind that Ofcom regarded these floors and ceilings as important?" to which he answered "Important, yes." (PPC Judgement §280)

⁴ For example in relation to TRC in 2011 LLU Charge Control Consultation (BT's Response §4.327)

what it actually assumed – we think a compliance investigation should be opened to get to the bottom of this question.

2.2 Was the obligation unclear ?

- 2.13 It is pertinent now to turn to the question of the level of clarity that was available to BT where BT seeks to paint Ofcom's policy on cost-orientation as wholly unclear. BT says for example:

Ofcom never made clear to BT, at the time when BT was setting the prices ... that BT would be expected to be able provide a separate justification for each and every price in the price list. (§ES34)

- 2.14 Before discussing the actual level of clarity it is worth noting that whilst BT argues that its obligations were all terribly unclear BT also argues in its response the exact opposite in that the obligation was well understood e.g.

Ofcom's approach to the assessment of cost orientation is now quite different from that which BT had been led to expect by Ofcom ... (§ES39a)

Ofcom proposes to depart from what was effectively a shared (historical) understanding of the approach which would be taken to cost orientation ... (§14)

[DSAC gives] BT the intended 'bounded' flexibility (§229)

- 2.15 Thus, on the one hand BT is arguing that Ofcom did not provide any clarity but on the other hand, BT says that Ofcom had indicated its approach. It is rather difficult to ascertain from BT what actually it is trying to say. Does it believe it was clear or unclear? Again BT seems to be switching its position in order to bolster its floundering defence.

- 2.16 Turning to the question of clarity. In reality Ofcom's policy has been articulated ever since Oftel/Ofcom published the cost-orientation guidelines in 1997 (they were re-issued in December 2001). These, in combination with HH3 outlined on the face that:

- 2.16.1 the cost orientation test (whatever that is) would be applied on 'each and every charge'. HH3 states:

... the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered,

- 2.16.2 DSAC was a 'first order test' of cost orientation though a price below DSAC might not be compliant (and visa-versa) as made clear in the 1997/2001 Guidelines. Thus although other 'second order' tests were not specified it was clear that DSAC would be considered in assessing compliance. BT's complaint that DSAC was not specified in the Condition HH3 itself (§52.2) is spurious since clearly HH3 has to be read in conjunction with the 1997/2001 Guidelines

- 2.16.3 there was a positive onus on BT to demonstrate to Ofcom that it complied with its obligations. HH3 states:

... the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered,

- 2.17 So turning back to BT's claim at §ES34 that 'Ofcom never made clear to BT ... that BT would be expected to be able provide a separate justification for each and every price'. BT is plainly wrong. HH3 makes plainly clear of the face that BT would have to justify the price of each charge. You don't need a law degree to work that one out.
- 2.18 What was also clear and/or obvious was that these obligations would be interpreted in light of the over-riding Directives and Ofcom duties. In particular, and as BT recognises itself, Art 13 of the Access Directive and Ofcom's duty to further the interests of consumers and promote competition will be central to the interpretation. These imply that the purpose of the cost orientation is to ensure that prices are economically efficient and support competition.
- 2.19 Thus the concept that BT was operating in a vacuum and that it had no idea of its obligations is fallacious.
- 2.20 Though BT's obligations were clear, the obligation was not highly *precise* – for instance, it did not set a maximum price in £ and pence for each product as would be specified under a charge control. However, it would be wrong to infer from this that such a lack of precision meant that it was impossible or difficult for BT to comply with the obligation or that compliance should be lax. We explain why below.
- 2.21 First, such a lack of precision is not unusual with regulations or indeed other areas of law. For example:
- 2.21.1 The Network Access obligation (e.g. HH1) is couched in general terms of what is 'reasonable' and 'fair' and there is no guidance on how this might be interpreted:
- Where a Third Party reasonably requests in writing Network Access, the Dominant Provider shall provide that Network Access ... HH1.2 The provision of Network Access ... shall occur as soon as reasonably practicable and shall be provided on fair and reasonable terms, conditions and charges*
- 2.21.2 The no undue discrimination obligation (HH2) is similarly couched in general terms:
- The Dominant Provider shall not unduly discriminate against particular persons or against a particular description of persons ... the Dominant Provider may be deemed to have shown undue discrimination if it unfairly favours to a material extent an activity carried on by it so as to place at a competitive disadvantage persons competing with the Dominant Provider.*
- 2.21.3 Most General Conditions are similarly worded in general terms. For example, GC5 regarding emergency planning is highly unspecific:
- ... Communications Provider[s] shall, on the request of and in consultation with: ... the authorities responsible for Emergency Organisations ... make arrangements for the provision or rapid restoration of such communications services as are practicable and may reasonably be required in Disasters.*

- 2.22 Thus it is nonsense to suggest that BT can only comply with regulatory obligations if those obligations are highly precise. BT (and indeed many other operators in the case of General Conditions) comply with imprecise obligations all the time.
- 2.23 Second, BT itself must have effectively accepted the implicit imprecision by its demands for 'light touch' regulation. It is wholly unreasonable for BT to now complain that there was a lack of precision where it had previously and expressly argued in favour of regulations that were imprecise.
- 2.24 Third, as we explain below, BT could have (and should have) complied with these 'imprecise' obligations by: developing a view of how a cost orientation obligation may have been interpreted given the Directives and Ofcom's prevailing duties; expeditiously setting prices that were consistent with this; and, erring on the safe side.

2.3 Given lack of precision what should BT have done?

2.25 The subsequent question, if BT was uncertain as to its precise obligations under a cost-orientation obligation, is what would have been a reasonable approach for BT to have taken to ensure compliance? We highlight below the steps we think BT should have taken. This reflects (a) that BT is a mature FTSE100 company with a substantial compliance and risk management department and (b) this was not a trivial matter – the products that were subject to cost orientation obligations (and not cost charge controls) had revenues of £100s of millions⁵. The steps BT should have taken were:

- 2.25.1 Seek clarity; and
- 2.25.2 Develop its own view on how Ofcom might interpret cost orientation and thus apply its own robust cost orientation tests and maintain an audit trail; and
- 2.25.3 Err on the safe side in setting prices

2.3.1 Seek clarity

- 2.26 The first thing that BT could/should have done is to seek clarity from Ofcom about how it might interpret the cost orientation obligation in the case of a dispute. For instance, BT could have requested that Ofcom develop and publish guidance or BT could have engaged with its customers in a constructive manner about how BT was meeting its obligations.
- 2.27 However, even though it is 15 years since the cost orientation obligation was first imposed on BT (in 1997), BT has not, as far as we are aware, taken any such steps. For instance, it cannot point to a single piece of correspondence that says: 'Dear Ofcom, please can you provide clarification' (or similar). BT has, it appears, tried to

⁵ In the case where a charge control applies the cost orientation condition does not need to provide any constraint on overall cost recovery

get Ofcom to 'approve' its prices but that seems directed at trying to pass the compliance responsibility to Ofcom and suggest that it was Ofcom's responsibility to provide clarity. For example:

[The discussion] included BT giving Ofcom significant amounts of cost information as to BT's pricing. If Ofcom had concerns or felt that BT needed to do more to justify its pricing, then Ofcom, as a regulator, should have given BT guidance at that stage.

2.28 In a similar vein, BT highlight that in 2007 they provided information to Ofcom on the basis 'that the information ... is to be used to assess BT's compliance with HH3' (§86). Ofcom did not use the data to assess compliance but did not respond to BT's comment. BT now argues that:

... if Ofcom was accepting the information for an entirely different basis to that on which it was proffered, it was incumbent on Ofcom to make it clear that it was not going to use the information for that purpose (§88)

2.29 BT's position is untenable – BT is simply attempting to pass off its responsibility onto Ofcom. If BT was so concerned in 2007 about this issue they would have asked Ofcom at the time to confirm whether they were compliant or not and if such confirmation was not forthcoming taken alternative steps. To come back and read something into a series of events that happened 5 years ago is simply trying to rewrite history.

2.30 It is, in our view, patently absurd for BT to complain of a lack of clarity as to how it should comply with its obligations when BT itself has for 15 years failed to seek such clarity. The onus is clearly on the regulated party to, if it is concerned about a lack of clarity, seek clarification.

2.3.2 Develop and implement robust compliance approach

2.31 In the alleged absence of precise guidance from Ofcom about how it would interpret cost orientation it would have been sensible for BT to have taken a number of steps to reduce its risk of non-compliance:

2.31.1 develop its own objective view of how cost orientation might be interpreted (and so create tests or checks for cost orientation);

2.31.2 ensure that the cost data it was using to check compliance of its charges was appropriately reliable and robust;

2.31.3 applied the tests and proactively adjusted prices to ensure that they pass the tests; and,

2.31.4 maintained an audit trail.

2.32 This would have been the normal approach to manage compliance obligations. We describe these steps in more detail below.

2.33 BT (or its advisors) could have quite easily developed an objective view of how cost orientation might be implemented. In particular, BT could have looked at the underlying purpose of the Directives, Communications Act, regulation and guidelines

to develop a well-informed view of how cost orientation might be interpreted. It is notable that in its response BT (rightly) emphasised the importance of competition / consumer impacts and economic considerations in assessing cost orientation:

- 2.33.1 From 1997/2001 Guidelines as quoted by BT at §50.1: “The primary focus of investigation of a complaint under Condition ... 13.4 [BT’s cost orientation condition] will however be the effect or likely effect of the charge on competition and on consumers”
- 2.33.2 BT notes the purpose implied in Art 13.1 of the Access Directive: “The general purpose of both [cost orientation and charge controls] is to ensure that BT’s charges are consistent with those that would be charged if the market in question was competitive.” (§204.3) And: “the Access Directive also recognises the need to consider the promotion of efficiency under cost orientation”. (§207.1)
- 2.33.3 BT rely repeatedly on Mr Myers (of Ofcom) statement of what cost orientation meant: “The overarching economic context is the regulatory balance to be struck between: a. providing the regulated firm with enough pricing flexibility to recover its costs, including its common costs, in an economically efficient manner; and b. ensuring that this flexibility is sufficiently bounded to prevent the regulated firm from exploiting its market power to set anti-competitive, exploitative or otherwise unreasonable charges.”⁶
- 2.33.4 BT said: “... [the] the weighing up of economic considerations which should be central to Ofcom’s balancing of duties to resolve disputes appropriately and fairly to all parties.” (§266)

2.34 In particular, BT could have (recognising the commonality of purpose for charge controls and cost orientation under Art 13 – see §204.1) examined the principles and approach underlying a charge control obligation to help inform it of how a cost orientation obligation might be interpreted e.g. even allocation of common costs, no overall over-recovery of common costs.

2.35 Therefore, we consider it perfectly reasonable to conclude that BT reasonably knew or, as a diligent SMP operator, should have known in 2005 (or before) that the underlying purpose of the cost orientation obligation was to ensure economic efficiency. BT could have then gone on to analyse what economically efficient prices might be. In particular, it would not have been complicated for BT to establish two core principles about the way in which cost orientation would be interpreted:

- 2.35.1 Cost orientation obligations would be applied in such a way to prevent BT from significantly over-recovering their overall costs particularly since in the case of WES/BES products there was no basket charge control to restrict overall returns⁷

⁶ From PPC Appeal WS Myers p18

⁷ In the case where charge control also applied then the cost orientation obligation would not need to provide a constraint on overall recovery

- 2.35.2 Cost orientation would allow some flexibility (§52.4) but would limit pricing flexibility on individual products to the level necessary to allow allocatively efficient pricing (but no more) – i.e. this was the ‘appropriate bounded flexibility’
- 2.36 From these BT could have developed a sensible set of tests / checks – for instance ceilings of FAC+30% on individual products and FAC+10% on groups of products and limits on overall recovery. At the very least, BT would have been able to conclude that charges above DSAC (for individual products) would be very unlikely be compliant with its cost orientation obligation.
- 2.37 Once it had developed a view of the appropriate test(s), BT could then have gone on to regularly assess its compliance. This would have sensibly involved:
- 2.37.1 Ensuring that its projected costs and actual costs data and records were timely, reliable and robust enough to be used to check the compliance of prices
- 2.37.2 Developing and implementing a clear process for regularly checking prices against projected and out-turn costs (particularly since costs were, according to BT, unpredictable)
- 2.37.3 If necessary, expeditiously adjusting prices to ensure they were compliant
- 2.37.4 Documenting an audit trail that it could provide to Ofcom so that, if it were required to demonstrate compliance as is clearly required by HH3, then it could do so
- 2.38 As far as we understand BT did none of this. For example:
- 2.38.1 it did not develop a view of the appropriate cost benchmark. In fact, even today it does not seem to have a settled view on what the appropriate cost benchmark is for the ceiling (see XXX below)
- 2.38.2 it did not ensure its cost information was reliable and its data was riddled with errors – as BT said: *“In truth the calculation of the DSACs received too little attention by BT”*
- 2.38.3 it seemingly had no formal or structured process for checking compliance
- 2.38.4 even when prices were significantly above DSAC it did not expeditiously reduce prices (see TalkTalk response §3.127)
- 2.38.5 it seemingly kept no record or audit trail of how it made its pricing decisions
- 2.39 Certainly, in its responses to Sky and TalkTalk BT described nothing of what it had done to ensure compliance. It simply stonewalled and asserted that it was compliant with all its regulatory obligations.
- 2.40 This approach to compliance is all the more surprising given how seriously BT says it treats compliance. The following are extracts from BT’s website and Annual Report about compliance:

BT's aim is to ensure that effective arrangements are in place to enable us to comply with our regulatory and competition law obligations. Support, advice and guidance to enable BT to meet these obligations are provided by the Group compliance team. This team works closely with audit, legal and regulatory experts, both within the Group and in each line of business, to ensure that operational management has the support it requires. The team's independence from the lines of business enables them to provide an objective assessment and to report and escalate risks and actions as necessary. There are a number of compliance forums in place to help deliver these activities on a consistent basis. There are also a number of formal reports provided on compliance performance and risk review findings.⁸

[The Board] approves ... the overall system of internal controls, governance and compliance authorities.⁹

The Audit & Risk Committee reviews BT's published financial results, the Annual Report & Form 20-F and other published information for statutory and regulatory compliance. It reports its views to the Board to assist it in its approval of the results announcements and the Annual Report & Form 20-F.¹⁰

- 2.41 In summary, BT's attitude to compliance with this important regulatory obligation bordered on negligent behaviour. One plausible interpretation is that they ignored the obligation thinking they could 'wing it'. The most kind interpretation for BT is that they did not give anywhere enough attention to the obligation and are now trying to rewrite history in a desperate attempt to avoid repaying the substantial amounts that it has overcharged in the past. Either way there is no excuse for prices that were non-compliant nor BT's failure to meet its obligation to demonstrate compliance.

2.3.3 Err on safe side

- 2.42 Generally, where a business faces compliance obligations the appropriate behaviour is to err on the safe side to reduce the risk and downsides of non-compliance (such as a fine of 10% of its revenue).

- 2.43 The need to play safe would be particularly high in this case since:

- 2.43.1 BT says that it was not clear how Ofcom would interpret BT's cost orientation obligations
- 2.43.2 BT had not (seemingly) developed its own view of compliance or implemented a robust process for checking compliance and adjusting prices
- 2.43.3 The onus was clearly on BT to demonstrate compliance and it would risk being fined up to 10% of turnover (same as a competition law) if it was found to have breached the obligation.

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<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Regulatorycompliancepolicy/Regulatorycompliancepolicy.htm>

⁹ BT Annual Report 2011 p63

¹⁰ BT Annual Report 2011 p65

- 2.43.4 There would be little economic harm from erring on the safe side and setting prices close to FAC¹¹.
- 2.44 BT did not have to price at the ceiling. The ceiling was just that, a maximum level, it could price below it if it wished. In this case, it was and is very obvious what the 'low risk' or safe approach would be – set prices close to FAC for each product and certainly never above DSAC. FAC was and is well understood and a well used cost standard that Ofcom used to set charge controls. If prices were set at or close to FAC (and overall recovery was close to FAC) then compliance would have been almost guaranteed.
- 2.45 However, rather than erring on the safe side by setting prices close to FAC, BT did the exact opposite and gambled by setting average prices at almost double FAC and in one case 3½ times FAC (and of course well over DSAC). To suggest that BT took a risk is an understatement. It adopted a careless and perilous approach when a low risk approach was obvious and indeed was the only reasonable approach to take given BT's view of the lack of clarity.
- 2.46 When assessing BT's compliance and if Ofcom considers that the ceiling was not precisely clear, then Ofcom must assess compliance against what would have been a sensible and low risk approach.

2.4 Conclusion on claimed in clarity

- 2.47 In our view it is plainly an intolerable and unacceptable defence for BT to come back after the event and ask for Ofcom to cut BT some slack because the obligations were unclear.
- 2.48 To suggest that Ofcom had not made it clear BT's obligations is an astonishing argument without any basis in historical events. It is clear on the face that it is BT's responsibility to ensure that the requirements of Condition HH3.1 are met at all times. BT cannot relinquish this responsibility simply by now saying that it was not aware of how its regulatory obligations might have been interpreted. If BT was unsure of precisely how the obligation might be interpreted then it should have developed its own objective test, actively checked its compliance and erred on the safe side. Instead, it appears that it ignored the obligation and/or was negligent and/or gambled.
- 2.49 It is only too convenient and wholly unreasonable for BT to blame Ofcom for lack of clarity as an after-hand construction. BT's case should be rejected in the strongest terms. Arguably, BT's cavalier attitude to compliance provides a case for a stricter interpretation of cost orientation to send a clear signal that such negligent and risky behaviour in respect of important regulatory obligations will not be tolerated.

¹¹ For instance, if all prices were set at FAC then the only economic loss would be a little bit of reduced allocative efficiency – see TalkTalk response §3.91. We do not consider the inability to excessively price services as a legitimate downside of pricing at FAC

- 2.50 Metaphorically speaking, BT's case is like someone who broke the speed limit now arguing that they should not be found guilty because though they knew there were maximum speed limits, they did not bother to look for the speed signs or check the speed they were travelling¹².

3 Approach to applying ceiling

- 3.1 Ultimately a key issue in assessing whether BT has met its cost orientation obligation is the cost standard(s) that are applied (and how they are applied). As we describe above there is no precise definition of what these are except that DSAC is a first order test on each and every charge.
- 3.2 BT does not directly address the question of the appropriate cost standard(s) in their response. This, in itself, is telling. Despite the fact that BT has a clear responsibility to comply (and to demonstrate that it complies) with this important obligation that has applied for 15 years, BT has not settled on a view of what the appropriate cost standard or measure is (for example is DSAC appropriate) or articulated any positive reason or justification as to why this might be the case. We find this void astonishing and another factor that demonstrates BT's negligence.
- 3.3 Our comments regarding the appropriate cost standard are explained in section 3 of TalkTalk's response. Below we comment on a number of aspects related to the ceiling that BT raise in its response.

3.1 Persistence of above ceiling price to warrant breach

- 3.4 BT made a number of comments about the duration of prices above DSAC that would be needed to constitute an overcharge. For instance it says in respect of BES1000 Connection:

BT again contends that the isolated single year nature of the price above DSAC is inconsistent with a finding of breach of cost orientation. There was no persistent transgression over the majority of the period. (§320)

- 3.5 And more generally:

Ofcom had never given any indication that it considered there could be a breach of the cost orientation obligation where BT's prices for a product exceeded DSAC in a single year out of five or six years. (§298)

- 3.6 We make the following points.

- 3.7 First, 'transgression' (i.e. prices above ceiling) for multiple years should not necessarily be required for a non-compliance finding or to require repayment.

¹² The analogy is that BT knew there were pricing limits, but BT did not find out what the pricing limits were nor did they pay any attention to whether its prices were likely to be within the limits

Economic harm can result from a transgression in one year (or even a period of months). To use an analogy: if a defendant has only committed robberies in three of the past five years it is not (as far as we are aware) a defence against a guilty finding (and nor does it eradicate the harm).

- 3.8 Second, it is plainly nonsense for BT to presume that a persistent transgression was required to find non-compliance since 'Ofcom had never given an indication' that above ceiling pricing in one year would be a breach. Why would not a transgression for one year constitute non-compliance? HH3 never said a one year transgression would be compliant, nor did the 1997/2001 Guidelines. Ofcom never said (prior to the end of the disputed period) that above ceiling pricing for only one year was not a breach. The reality is that Ofcom was silent on the matter – for BT to read anything into that silence is plainly ridiculous.
- 3.9 Third, whether there is a non-compliance or not must reflect the degree of transgression. For instance, if prices were 2% above ceiling for each of 5 years then it might not constitute non-compliance (since it may have been difficult to predict the ceiling) but a price of 50% above ceiling in only one year might be.
- 3.10 Fourth, since BT could or should have been able to get reliable monthly cost data they would have been able to identify and correct prices above ceiling quickly.
- 3.11 Ofcom has taken the right approach by analysing the circumstances of those charges in the case where revenues exceeded DSAC in fewer than three years. For instance, in relation to BES100 rental, Ofcom states:
- BES100 connection revenues exceeded DSAC for 2006/07 and 2007/08. As discussed in Section 11, when revenues exceed DSAC for less than three years, consideration of the circumstances of the charges is necessary. Revenues were also above FAC in both years and substantially so in 2006/07. This evidence supports a finding of overcharging in 2006/07 and 2007/08.¹³*
- 3.12 It is not possible to adopt the mechanistic approach advanced by BT but rather one has to, as Ofcom has indeed done, look at a range of relevant evidence over the period of investigation.

3.2 Ceiling was not set at FAC+85% by the CAT

- 3.13 BT seem to suggest that the PPC Determination / Judgement determined that the appropriate cost orientation ceiling was 85% above FAC (since DSAC is FAC+85% – see §262). BT go on to imply that (a) FAC+85% is the appropriate ceiling for WES/BES and (b) since WES/BES prices were only 37% above FAC then they are compliant. Both the theory and the specific numbers behind this claim are wrong:
- 3.14 First, BT's comparison is a false and inappropriate one:

¹³ Draft Determination, §13.44.

- 3.14.1 BT is comparing apples and pears since it is comparing one service (PPC 2M trunk) to an aggregation of many services (all AISBO)
 - 3.14.2 we know that (and BT agree that) cost orientation must be assessed for each and every charge so an aggregated test across multiple products/charges is inappropriate
 - 3.14.3 BT effectively aggregates over several years which is not how the cost orientation test is applied
- 3.15 Second, DSAC for WES/BES is not 37% above FAC. BT has not explained how it got 37% but it seems:
- 3.15.1 BT's analysis is based on the published RFS DSAC numbers before adjustment to remove errors¹⁴ – clearly it is inappropriate to use erroneous numbers
 - 3.15.2 BT's numbers include (we think) internal supply. This is clearly inappropriate since cost orientation must be judged by reference to external supply only
 - 3.15.3 In any case, for the key WES/BES services¹⁵ that formed the Sky/TalkTalk dispute the error-corrected DSAC costs were on average 95% above FAC and in one case DSAC was 257% above FAC
- 3.16 BT's point here does though demonstrate that BT considers that it is appropriate to consider compliance by assessing how much prices are above FAC. We agree that this is a good (and indeed better) approach to assessing compliance (than using DSAC). We disagree though that 85% above FAC (or even 95%) is the correct level. As we described in our response we consider FAC+30% is ample to allow allocative efficiency benefits (see TalkTalk submission §3.92).

3.3 Other aspects regarding ceiling

- 3.17 Though BT argues that the use of DSAC as a ceiling was not clear at other times it contradicts itself and suggests that DSAC is in fact the appropriate ceiling. For instance:
- [DSAC gives] BT the intended 'bounded' flexibility (§229)*
- ... prices which were 85% higher than FAC [i.e. DSAC]; this level represents the 'reasonable balance' [§262.1]*
- 3.18 BT also try and imply that DSAC is the minimum or lowest ceiling that would apply (i.e. that second order tests would set a ceiling that was at or above DSAC) – see §ES26. This is plainly not the case. The 1997/2001 Guidelines are clear that a price below DSAC might not be compliant depending on circumstances.

¹⁴ this is implied by §264.2

¹⁵ WES/BES includes (in line with Ofcom's approach): external services only (i.e. not including internal); BES100 rental, BES100 connection, BES1000 rental, BES1000 connection, WES10 rental, WES100 rental, WES1000 rental and main link; in each of 06/07, 07/08 and 08/09 . See TalkTalk submission endnote (i)

4 Aggregation of rental and connection

- 4.1 The level of aggregation used to test cost orientation (and assess overcharge) is important – the higher the level of aggregation the ‘weaker’ the test. BT had previously argued for a very high level of aggregation that tested cost orientation only at the level of all WES/BES services together¹⁶.
- 4.2 We are pleased that BT has accepted that its previous position was untenable. BT have agreed (§223) that cost orientation should be done for each product i.e. BES separately from WES, main link separately from local end and different speeds separately (e.g. BES100 separate from BES1000).
- 4.3 However, BT has maintained its position that rental and connection (for each product) should be aggregated. We consider this inappropriate for the following reasons:
- 4.4 First, the HH3 obligation is for ‘each and every charge’ to be cost orientated. It does not say that ‘each and every service’ should be cost orientated. BT (at §166ff and §185) attempt to imply that the cost orientation obligations relate to services. BT state:
- Condition HH3.1 refers to “each and every charge [for a service]”*
- 4.5 But the extra words ‘for a service’ are not found in HH3 and the meaning that BT attempts to imply is inconsistent with the very wording of HH3. Rental and connection are different charges and thus it follows that each should be tested separately. In any case it is worth noting in this regard that the 1997 guidelines actually list connection and rentals as separate BT standard services.¹⁷
- 4.6 BT highlights that the 1997 guidelines “recognised the limitations of relying solely upon individual component costs”¹⁸ and that Oftel therefore “specifically accepted that looking at the floors and ceiling for individual components was not to be used as the test for abusive charging.”¹⁹ BT appears to suggest that this fact (that tests are not applied on individual components) supports its argument that connections and rentals should be assessed together. This is not a tenable proposition and TalkTalk believes BT is seeking to read into guidelines words and meanings that are simply not there. The guidelines simply refer to the fact that BT network services are built up of network components just as BES and WES services are built up of various network components. Indeed BT publishes DSAC values for each network component in its RFS on an annual basis.²⁰

¹⁶ including we think internal supply

¹⁷ 1997 Guidelines, Annex A.

¹⁸ BT submission §50.3.

¹⁹ BT submission §50.4.

²⁰ See *(Distributed Stand Alone Cost (DSAC) of Network Components)* of the Primary Accounting Documents which BT published each year throughout the Relevant Period. For example, the 2009/10 Primary Accounting Documents:
<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2010/PrimaryAccountingDocuments2010.pdf>.

- 4.7 Second, rental and connection revenues and costs are split out in the cost orientation section of the RFS implying that BT understood that cost orientation tests were to be made on rental and connection separately. Whilst the RFS are not necessarily determinative in terms of the appropriate level of aggregation (not least since the RFS are more aggregated than the appropriate tests²¹) they are informative of the minimum level of disaggregation.
- 4.8 Third, if rental and connection charges are misaligned from their costs then it can give rise to a number of harmful distortions
- 4.8.1 An aggregated approach to cost orientation could allow BT to, for instance, set connection charges at zero which might be anti-competitive. As we describe below (§§§) just because connection charges are below DSAC in some competitive retail markets it does not follow that zero or low connection charges are not anti-competitive or economically inefficient in this wholesale WES/BES market
- 4.8.2 Different CPs purchase circuits for different lengths of time meaning that there will be some distortions between customers²². In particular some CPs paid zero BES connection fees for a period in 2005 since LES circuits could be migrated to BES free of charge
- 4.8.3 These misalignments will give rise to distorted investment decisions on individual circuits and thus distorted competition
- 4.9 Fourth, if rental and connection charges were aggregated it would allow BT to game the system by having high connection charges in the early years and reduce them later. Thus in principle even if aggregation were appropriate (which for the other reasons given here it is not) it would be inappropriate to aggregate connection revenue in a year with rental revenue in a year. Instead connection revenues would need to be amortised in some way.
- 4.10 Lastly, the substantial latitude to price above FAC (and as low as DLRIC) allows BT ample flexibility to adjust prices to demand.
- 4.11 Thus we believe that it was clear that cost orientation would be tested for each of rental and connection separately and also that it is appropriate to ensure economic efficiency.
- 4.12 BT also raise three other reasons as to why aggregation of rental / connection is the correct approach.

²¹ For example, BES622 is not separated out in the RFS yet a cost orientation obligation applies on this individual product

²² Ofcom emphasises that it only makes sense to look at rental and connection together if they are bought in fixed proportions. Ofcom's draft determination in this dispute does not contradict the Gareth Davies letter in any way and in fact clearly follows Ofcom's policy on cost orientation. Specifically in relation to whether connections and rentals should be assessed together, Ofcom does find that contract periods do vary and that therefore is a risk of competitive distortion if rental and connection are assessed together. Ofcom draft determination, §8.73

- 4.13 BT say that aggregation is consistent with recent accounting practice (§187ff). It is not clear why a draft proposal (that no one has adopted) regarding the approach to preparing accounts is relevant to an assessment of WES/BES cost orientation in 2005 to 2009 which anyway principally concerns economic matters. BT do not provide any such explanation. This argument is irrelevant and spurious²³
- 4.14 BT say that aggregation is consistent with some competitive markets such as mobile where upfront costs (e.g. handsets) are not recovered in connection charges but are instead recovered in rental charges (§196ff). We think this is not a sound reason. First, that it happens in one case does not prove that it is appropriate for such an approach to be used for WES/BES charges. Indeed there are many examples in competitive and non-competitive markets where upfront costs are recovered in connection charges e.g. burglar alarms, MPF migration charges, IPStream connection charges. Second, this type of ‘cross-subsidy’ is rare in wholesale markets and are primarily used in retail markets – obviously WES/BES are wholesale services. Third, in the case of mobile there are minimum contract periods so there is a guarantee of on-going revenue.
- 4.15 BT suggest that they had a ‘shared historical understanding’ with Ofcom that an aggregated rental / connection approach to assessing compliance was appropriate highlighting the 2009 Leased Line Charge Control and the letter from Gareth Davies in December 2010 (§14, §200.2). BT says (§217):
- ... BT relied upon the 6 December [2010] Letter as meaning that connections and rental prices may be viewed together for the purpose of both demonstrating and assessing compliance with the basis of charges obligation.*
- 4.16 This is mistaken. The first and obvious point regarding the LLCC and letter is that they occurred after most of the disputed period. Therefore, it is unclear (unless BT had a crystal ball) how it took the contents of this letter into account when ‘demonstrating and assessing compliance’ of the charges it set in 2005. Second, on a proper reading the Gareth Davies letter is not (as BT argue) ‘inconsistent’ with a disaggregated approach (§200.2)²⁴. Third, this is inconsistent with BT’s claims that they were not aware of their obligations.

²³ BT have a track record of introducing spurious and irrelevant argument – for example, the international price benchmarks

²⁴ For example, BT claim that the letter supports an aggregated approach where as in fact the letter say that it would only make sense to do so if connection and rental are bought in fixed proportions (which they are not). The pertinent part of the letter is: “*With regard to the question of connections and rentals, we recognised in the PPC appeal that it made sense to look at services together if they are bought in fixed proportions. Connections and rentals have an element of fixed proportions through minimum contract periods, although there is also a variable element as contract periods vary. This is one of the issues we would be likely to consider in an assessment of cost oriented charges for those WLA services which are subject to the cost orientation requirement.*”

5 Cost predictability

- 5.1 The cost orientation requirement is effectively an obligation to set prices with reference to actual out-turn costs. This results in a need to set prices before costs are known for certain and so prices need to be set with reference to projected costs. Setting prices based on projected costs is something every business has to do and so forms part of normal commercial and financial practice.
- 5.2 BT makes much of the difficulty in predicting costs as a reason for non-compliance: *“There was so much uncertainty as to costs and demand that it was very difficult for Openreach to set cost orientated prices.”* (§341.1). Its explanation for this statement appears to be:
- 5.2.1 There was a ‘significant and unanticipated explosion in demand’²⁵ (§43.2). This is relevant since if costs are fixed then unanticipated demand can result in forecast errors in unit costs – for instance, higher than predicted demand can result in lower than predicted unit costs
- 5.2.2 It did not know the component costs. For example: ‘BT had limited information on historic costs’ (§107); ‘there was very limited data available’ (§322, §331); ‘forecasting the portfolio mix and the attendant costs of the portfolio [was] difficult’ (§338.3.3)
- 5.2.3 CVRs (cost-volume relationships²⁶) were not known (§76)
- 5.3 This is, in short, bunkum. The reasons are:
- 5.4 First, the level of sensitivity of unit costs to demand volume depends on how much of the cost is fixed and variable. If all the costs are variable then the unit cost will not depend on volume (and therefore unpredicted volume changes will not affect projected unit costs). The main category of fixed costs for WES/BES products will be duct and fibre that account for about 35% of WES/BES costs²⁷. Duct/fibre costs are also shared between different products (i.e. fixed and common costs). This means that the unit WES/BES duct and fibre costs are not in fact very sensitive to volume because, though the total duct cost is mainly fixed, an increase in volume of WES/BES attracts an increased allocation of the total cost.
- 5.5 We explain this in more detail in Annex 1 and also provide a worked example that shows that for costs such as duct and fibre the unit duct cost for WES/BES is not highly sensitive to demand – a 40% increase in volume only results in a 3.5% reduction in unit costs. Given most cost is variable or fixed and common then volume changes will not have a significant impact on unit costs.

²⁵ In and of itself, lack of predictability of demand is not relevant to cost orientation. It can have two relevant impacts. First it can make predicting unit costs difficult (as described here). Second, it can increase the volatility of returns and so cost of capital. We discuss cost of capital impacts in Section XXX

²⁶ cost-volume relationship i.e. how costs change in response to increased volumes. A CVR of 1.0 implies costs change in proportion to demand i.e. are fully variable. A CVR of 0.0 implies that costs do not change in response to higher volumes i.e. are fully fixed

²⁷ Derived from RFS for AISBO

- 5.6 We also note that it appears that the ‘unanticipated demand explosion’ was only for WES and not BES (see §67). This is not surprising since BES demand is highly linked to exchange unbundling which plans were known 12-24 months in advance.
- 5.7 Second, the costs of the main components that make up BES/WES and their CVRs were well understood and BT had ample information about them.
- 5.7.1 Duct and fibre (35% of total cost) have been around and used by BT for years
- 5.7.2 Even Ethernet equipment (i.e. to put at each end of fibre) (20% of total) had been used by BT for several years
- 5.7.3 Customer support and general management (35%) costs are not new activities
- 5.7.4 The only element that was new was its system build but this was probably less than 5% of the total costs and in any case BT had many years of experience of system builds.
- 5.8 Third, it is important to note that BT claims about cost unpredictability are just that, claims. Though no doubt BT made costs projections and they knew the cost out-turns they have provided zero empirical evidence to show that they made errors in forecasting costs or the source of any errors.
- 5.9 BT also make much that they did not know the costs until the RFS were published which was about 6 months after the year end and so could not align prices to out-turn costs e.g.
- ... it is simply not fair to require BT now to make repayments under s.190 (2) (d) of the 2003 Act on the basis of information it did not have and could not have accurately forecast at time. (§307)*
- 5.10 It is plainly wrong to suggest that BT did not know what its costs were for the financial year until the RFS were published 6 months or so after the end of the year. It is true that the final audited RFS were not available until after the year end but BT would have had available cost estimates much much earlier. BT no doubt produces monthly management accounts. It could have made frequent and timely FAC/DSAC cost estimates and it could have adjusted WES/BES prices based on those. That it did not do this can be no reason for finding non-compliance.
- 5.11 In a similar vein, BT refers to the PPC judgment where the CAT was saying that due to possible difficulties in predicting costs that *“it may be quite difficult for a regulated firm in the position of BT to ensure that its prices meet its cost orientation obligation, even if it has the firmest of intentions of doing so.”*²⁸ What BT fails to mention is that the CAT continued in its reasoning in the following paragraph by referring out to a witness statement by Mr Myers of Ofcom. The CAT first emphasised that *“we are not suggesting that this means that complying with Condition H3.1 is impossible.”* The CAT then referred to the witness statement in which Mr Myers stated that he *“would expect BT to have an understanding of its*

²⁸ BT submission §77, CAT judgment §299.

own costs, and it shouldn't be reliant on the publication. It should know what is happening to its own costs before the Financial Regulatory Accounts are published at that year-end."²⁹

- 5.12 This is an important observation by Ofcom. BT can and should have visibility of its costs on an ongoing basis to ensure that its senior management can operationally make any adjustments to prices throughout the year if necessary. This comes back to the fact that it is BT's responsibility to comply with its regulatory obligations. This is an active and positive responsibility which means BT cannot simply expect Ofcom to inform it when it should be doing something differently.
- 5.13 Thus in summary, BT's cost unpredictability arguments are a vacuous excuse without any real world foundation. There was no particular difficulty in predicting costs since contrary to BT's unevicenced and false claims, unit costs were not highly sensitive to demand and the cost components were well understood. Further, BT did not have to wait for its RFS to find out actual costs.

6 DSAC cost adjustments

- 6.1 In this section we address BT's submission regarding adjustments to the DSAC numbers – first, the corrections that Ofcom has applied (21CN and payment terms) and second, additional corrections that BT is proposing that Ofcom has rejected.

6.1 21CN equipment costs

- 6.2 WES/BES services were provided over so-called legacy technology. BT developed and deployed never 21CN technology to offer Ethernet services such as EBD and EAD that are in some respects similar to WES/BES. Ofcom have adjusted WES/BES costs from the RFS to exclude 21CN costs since they consider that 21CN should not be included.

- 6.3 BT argue (133ff) that the correction to exclude 21CN equipment costs should not be applied i.e. that 21CN costs should be included in WES/BES costs. BT argue that they are relevant costs since:

the 21CN and BES and WES services are closely related services meeting the same customer need (to transmit large volumes of data at high speed) so that the 21CN costs should be regarded as part of the forward-looking costs of providing customers with high speed data services (§131.1)

- 6.4 BT seem to suggest that the relevant costs are both 21CN development costs and 21CN equipment costs. In respect of development costs they claim that these costs would not be recoverable if they are not recovered in WES/BES since in future they would be considered sunk.

²⁹ CAT judgment §300.

- 6.5 It is difficult to ascertain BT's logic here but BT seem to be suggesting that since customers may in time purchase these newer/better services then it is appropriate for WES/BES charges to include these costs. We think that this is wholly illogical – we explain below.
- 6.5.1 These costs are not the forward looking costs of providing WES/BES services – they are the costs of providing different products: EAD and EBD. The 21CN development cost and/or equipment costs are not necessary to provide WES/BES services and there is no logic for WES/BES customers to pay these costs. The fact that they are 'related' is spurious. The concept that since WES/BES services are 'high speed data services' (in §131.1) is also spurious – on BT's argument broadband services and PPCs should be allocated 21CN costs that they do not use since they too are 'high speed data services'
- 6.5.2 If BT is concerned about appropriate sunk development costs not being recoverable in future then the answer is to ensure recovery of these costs in EAD/EBD rather than try and recover them from a different service
- 6.5.3 Cross-subsidising future products costs from current products is likely to result in a range of distortions between different customers and competitors and thus economic inefficiency. For instance some customers may not want to upgrade to the new technology yet would be required to pay the cost of the new technology.
- 6.5.4 It may be that BT is suggesting that WES/BES services are costed on the basis of the 'modern efficient asset' (or MEA) approach rather than the anchor based pricing approach that Ofcom has used (whereby products are costed on the basis of legacy equipment). It is notable that BT has previously agreed with using an anchor based pricing approach³⁰. However, if an MEA approach were used then WES/BES-like services would be costed using new technology throughout – thus 21CN equipment/development costs would be included but legacy costs would be excluded – you cannot, as BT suggest, count costs twice. Further, MEA costs would only be used if they were lower than legacy technology costs thus using legacy technology costs (as Ofcom has) represent the highest possible cost.
- 6.6 BT's position can be compared to a car company that sells slow cars but is developing a new car with a new faster engine. What BT is trying to do is to recover the cost of developing and making the new cars from customers of its existing slow cars on the basis that the cars are 'related' and because the customer of slow cars might buy faster cars in the future. It would not happen in a competitive market, it is not economically efficient and it should not be allowed here

³⁰ See 2009 Leased Line Charge Control §3.182. An anchor based approach was previously referred to as technology neutral approach (even though it was anything but technology neutral)

6.2 Payment terms

- 6.7 BT contend (135ff) that the working capital should not be based on required payment timing (under contract terms) but rather actual payment timing (which on average is later than required payment dates). BT seem to have forgotten to mention that BT is entitled to levy interest payments (at 4% above base lending rate) and this potential income would have to be included if actual payment timing was to be used. Thus BT's approach is partial and inconsistent. If BT's approach is adopted then customers will pay twice for late payment – once through late payment charges and secondly through higher WES/BES prices.

6.3 BT's proposed adjustments

- 6.8 BT has proposed that in addition to the other cost adjustments further adjustments should be made. These are:
- 6.8.1 BES fibre costs
 - 6.8.2 Provisioning costs
 - 6.8.3 ISDN monitoring costs
 - 6.8.4 Split cost category method
- 6.9 BT argue that these are similar types of errors to those which Ofcom has corrected for and should accordingly be included. We firmly disagree. The BT errors are distinguishable from the corrections that Ofcom has made and thus these errors (even if they were accurate) should not be included.
- 6.10 First, BT seem to suggest that Ofcom has only included adjustments that work in CPs' favour and against BT. This is not correct. Some of the corrections in some years increase costs and so reduce the overcharge³¹.
- 6.11 Second, it is no coincidence that all the four errors that BT happens to have found act in its favour. Of course, BT has no incentive to look for errors that were against or disclose such errors if it found them. Thus including these types of errors would create an intolerable inequity and asymmetry whereby BT could find errors in its favour but other CPs did not have the ability to find errors that work in their favour (since they do not have access to the model). This would have awful consequences:
- 6.11.1 It would create systematic bias in increasing costs
 - 6.11.2 It would create the incentive for BT to leave errors in its cost models so that it could 'discover' errors in the future to suit its cause
 - 6.11.3 BT has the ability to delay resolution of disputes by (as it has done here) discovering errors at the last minute
 - 6.11.4 By making these adjustments it is able to bypass any scrutiny by an auditor

³¹ see RGL Report Table 16. Though these are not the final figures used by Ofcom they are likely to be similar (the actual figures have been redacted)

- 6.11.5 This would allow BT to 'slosh' costs between disputes over time continually find errors to justify a reallocation of costs. This would mean that a single cost could effectively be counted in the costs of more than one product
- 6.12 Third, whereas the volumes errors Ofcom included were mathematical/software errors BT's adjustments are corrections for previous 'misapplication' of BT's own selected allocation methodologies. Given that the allocation methods are to some degree arbitrary then the nature of BT's errors are less 'hard-edged'.
- 6.13 Fourth, in the case of all these errors the increased cost for WES/BES is counter-balanced by a reduced cost elsewhere (since the adjustments are a reallocation of costs). However, BT is not proposing to implement the reduced cost adjustments elsewhere – some of the products from which the allocation has happened may have been charge controlled in which case the costs used to set charges were inappropriately high (according to BT).
- 6.14 BT seem to suggest that this is OK since the cost reductions elsewhere are 'not material' (§149). This is plainly absurd – if an increase of (say) £5m in costs in WES/BES is material then the £5m reduction in other costs is equally material³². Further, BT has not explained how the reduction in cost of other areas will be repaid to customers of those other products.
- 6.15 Fifth, in all the cases, the level of justification and explanation is wholly inadequate. For instance, the method and assumptions used to calculate the cost and allocate costs have not been articulated and the evidence and justification not provided³³. If these type of adjustments were allowed (which they should not be) then they will require very strong scrutiny³⁴.
- 6.16 Sixth, in regard to the new split cost category method we have asked RGL to review BT's proposal. RGL have informed TalkTalk that they do not see particular merit in the proposal:

i) The information presented is redacted so it is impossible to place the argument in any sort of context. ii) Without seeing how BT's LRIC model works in its entirety, it is difficult to reasonably comment on whether BT's existing methodology (as opposed to its new one) is flawed. iii) Thirdly, the explanation given is not particularly clear and does not explicitly set out why the new approach is better apart from to say that more FCCs should be allocated to .1 products. Indeed BT claim that "FCCs are being inadvertently allocated away from local services to an extent that has no economic rationale." BT does not demonstrate why this is the case, or why this outcome is particularly 'perverse'.

³² BT may be suggesting that the cost reduction is not material since it is a low % cost increase elsewhere. However, it is not the percentage difference that matters but the absolute amount.

³³ By way of a single example, BT use the years 2009/10 and 2010/11 as proxies for fibre costs in all other years. They justify this with a single sentence "There is no reason why fibre costs should vary significantly between years, except for the volume input error." §144. BT should demonstrate why they expect these costs to remain static.

³⁴ They would arguably need more scrutiny than in other cases where costs are assessed (such as charge controls) since the impact of these changes (if allowed) might be an increase in costs and prices without any offsetting reduction in costs and prices elsewhere

Despite the limitations outlined above, based on the complex explanation given by BT, RGL considers that having a different level of aggregation for FCCs and LRICs is not sufficient to make the existing framework wrong or inappropriate. By their nature, FCCs will be considered at a different level of aggregation than LRICs as they are “Common”. Rather than the new approach being correct, where the existing RFS approach (also devised by BT) is flawed, RGL views BT’s new approach as simply another methodology – and one which is favourable to BT in this instance.

- 6.17 BT’s approach here demonstrates BT’s arrogance in that it thinks it can seven years after it started breaching its cost orientation obligations fiddle the figures to reduce the overcharge it must repay. Ofcom must not allow such behaviour.
- 6.18 Regarding the proxy calculations, without further information we cannot provide any comment.
- 6.19 We also note that BT appears to support a proportional approach to calculating DSAC cost adjustments from FAC cost adjustment rather than an absolute approach (this is implied by the use of DSAC:FAC ratios in §§147, 148, 153). Ofcom proposed using an absolute approach. We agree with the use of proportional adjustments or a mix of the two (see TalkTalk response §§5.32-5.34).

7 Other issues

- 7.1 In this section we discuss a number of other issues raised by BT in its response.

7.1 BT’s discussions with Ofcom

- 7.2 BT make much of its discussions with Ofcom regarding the pricing of WES/BES services – see §§70-84. Though there are vague as to the conclusion they draw, BT appear to seek to imply that this dialogue constituted some form of approval by Ofcom or that the dialogue meant that the onus was on Ofcom to tell BT what to do to be compliant. For instance BT says:

[The discussion] included BT giving Ofcom significant amounts of cost information as to BT’s pricing. If Ofcom had concerns or felt that BT needed to do more to justify its pricing, then Ofcom, as a regulator, should have given BT guidance at that stage. (§70)

- 7.3 BT’s suggestion is widely misguided in three respects.
- 7.4 First, as BT must know, it is their responsibility to comply with its cost orientation obligation. This responsibility cannot be handed back to Ofcom.
- 7.5 Second, Ofcom did not have the legal powers to ‘approve’ BT’s prices in some closed room agreement not least since it is unable to fetter its discretion in respect of future disputes.

- 7.6 Third, what is plainly clear from BT's description of the discussions is that Ofcom made no commitment regarding how it would interpret cost orientation or in any way approved BT's prices – the extensive quotations are principally about what BT said to Ofcom not what Ofcom said to BT. Whilst this might be frustrating for BT in that Ofcom did not do what it wanted it to, it cannot provide an excuse for non-compliance. Ofcom's silence on the issue cannot be taken as tacit approval.
- 7.7 In a similar vein, BT rely on a decision in respect of a dispute submitted by Thus plc in 2007 (§89) where Ofcom chose not to open an investigation and say that, on the basis of that decision BT was 'fully entitled to conclude' that all cost orientation issues would be tackled in the upcoming Leased Line Market Review. This is plain nonsense to suggest that a decision to close a dispute constituted Ofcom signing away its powers to resolve a dispute regarding cost orientation.

7.2 Other pressures

- 7.8 BT argues that a whole host of other factors must be taken into account, justify a lax approach and/or excuse BT altogether from non-compliance. For instance:
- 7.8.1 Was a nascent market (§ES37b)
 - 7.8.2 BT's equivalence obligations and consequential reorganisation (§316)
 - 7.8.3 Need to introduce new products (§§55.2, 93.1.3, 335.4.1, 338.1)
 - 7.8.4 Challenges from cost management (§55.1)
 - 7.8.5 BES/WES has helped make a 'very positive contribution' to competition (§9, §111)
 - 7.8.6 Did not want to penalise customers who had paid higher prices previously (§100)
 - 7.8.7 (Unspecified) price signals (§93.1.4) and other pricing constraints (107)
- 7.9 BT seem to misunderstand its regulatory obligations. They are not some optional exercise that they need only do if they are not busy elsewhere. Rather they are serious obligations that must be complied with. In any case, most of the points that BT raise are wholly irrelevant – for instance:
- 7.9.1 Equivalence obligations did not affect pricing at all
 - 7.9.2 The fact that WES/BES helped competition is all the more reason to get pricing compliant rather than allow it to be anti-competitive
 - 7.9.3 The efforts required to re-organise and introduce new products cannot justify neglecting a regulatory obligation
 - 7.9.4 The fact that previous customers had paid excessively high prices is no reason to continue excessive pricing levels
- 7.10 With regard to the nascency issue, TalkTalk agrees that the AISBO market was growing fairly rapidly during the period of investigation. However, contrary to BT's assertions, Ofcom took this expected development into account when it imposed the

cost orientation obligation on AISBO services in 2004. Indeed, Ofcom stated “AISBO services were a nascent market and that imposing a charge control at that time was inappropriate and could impede market development.”³⁵ In other words, Ofcom considered that BT should be regulated in a lighter manner by imposing only a cost orientation obligation rather than imposing a heavier regulatory obligation in the form of a charge control. Contrary to what BT appears to suggest³⁶, Ofcom did not consider in 2004 (and there is no evidence to support it) that the AISBO market was so nascent that a cost orientation obligation should be interpreted in a more relaxed way.

7.11 Of all the many factor highlighted by BT, the only possibly legitimate issue would be the possible objective of allowing a margin for competing operators providing their own trunk network (§§71, 93.1.2, 316.1). However, an amply adequate margin would have been achieved by prices a few percentage points above FAC. The need for a margin cannot justify prices as high as DSAC or even higher.

7.12 Thus TalkTalk believes these arguments must be rejected by Ofcom.

7.3 Effects assessment

7.13 BT argue that Ofcom must conduct an ‘effects assessment’ since this was mentioned in the 1997/2001 Guidance:

Where guidance has been given by Ofcom (or previously Oftel), Ofcom in the Draft Determinations has radically (and unfairly) departed from that approach, including not carrying out an effects assessment. (§44)

7.14 BT is not clear what it means by an ‘effects assessment’ though they say at §ES37c there should be ‘an investigation of the economic impact of the pricing concerned’.

7.15 We would agree that it is appropriate for Ofcom to consider the economic effects of BT’s prices and in particular assess whether the prices were economically efficient. However, if what is meant is trying to quantify and measure the impacts on CPs, customers and market structure then we disagree.

7.4 Precedents and consistency

7.16 We note that BT refers extensively and repeatedly to other Ofcom statements (e.g. Leased Line Market Review 2009, Letter from Gareth Davies Dec 2010, Leased Line Charge Control 2009, PPC Dispute Determination in 2010) and the CAT PPC Judgements. Ofcom must be careful about how it uses these since all of these occurred after the disputed period and therefore could not have effected how BT set the disputed prices or how it assessed its compliance. BT’s claims that they are relevant are obvious nonsense:

³⁵ Paragraph 5.46 of the Leased Lines Charge Control Consultation, 8 December 2008.

³⁶ BT submission, §60.

... BT relied upon the 6 December [2010] Letter as meaning that connections and rental prices may be viewed together for the purpose of both demonstrating and assessing compliance with the basis of charges obligation (§217)

- 7.17 These other statements may though have some relevance if Ofcom considers the consistency of its approach in this dispute with these other decisions. In respect of the question of consistency we make the following points (in respect of all Ofcom decisions):
- 7.17.1 Consistency is no reason for maintaining an erroneous approach. A key benefit of consistency is that it reduces uncertainty and risk and so encourages efficient investment
 - 7.17.2 Ofcom cannot fetter its discretion in respect of resolving this dispute by decisions it makes elsewhere
 - 7.17.3 Ofcom's decision in respect of this dispute must reflect the particular circumstances of this dispute. In this regard the WES/BES dispute is manifestly different to PPC Trunk (where only one service was involved and across all PPCs there was no over-recovery) and Interconnection services (where the cost orientation applied but the obligation did not have to provide any constraint on overall recovery)
- 7.18 In respect of the CAT PPC Judgement it must be recognised that the judgement was confined to the specific points raised in BT's Notice of Appeal. Therefore, it did not consider, for instance: whether FAC+30% was an appropriate ceiling; and, whether over-recovery on PPC was offset in other services. Further, the context is clearly different.

7.5 Overcharge and restitution arguments

- 7.19 BT claims that Ofcom errs in its application of section 190 of the Act with regard to the amount of repayment. BT's arguments are not easy to follow and, indeed, the Competition Appeal Tribunal said that they could not understand them (§338(3) of the Judgment in PPCs³⁷). Essentially, though, BT's arguments appear to amount to a confusion of the statutory regime under which Ofcom decides disputes with certain principles which might apply if this were a claim for contractual (or possibly tortious) damages. To that extent it is unnecessary to grapple with BT's arguments (although, without prejudice to that, we do offer some comments on them below).
- 7.20 The right approach is simply to apply Ofcom's jurisdiction in the Communications Act and interpret what it says on its face. The power in section 190(2)(d) is absolutely crystal clear: where Ofcom determines the proper amount for a charge, it may give a direction requiring the adjustment of an overpayment (including interest as applicable). This is exactly what Ofcom proposes to do.

³⁷ BT v. Ofcom [2011] CAT 5

- 7.21 To this extent the regime may appear to be ‘restitutionary’ in a non-technical sense. This does not mean it falls to be analysed in the scheme of case law on restitution in a technical sense (which relate primarily to cases on contract or proprietary torts) as BT has claimed.
- 7.22 A simple analysis of BT’s arguments serves to confirm this. BT relies heavily on the concept of counter-restitution, citing in support, amongst other cases, that of Spence³⁸. In Spence, a contract was agreed for the sale of shares in a company. However, the seller had relied on a misrepresentation by the buyer. The seller sought the return of the shares and was entitled to it. The Court also ordered that the seller must return the money that he had been paid by the seller for the shares. Without commenting on that case in detail, the sense of the decision is pretty obvious in that there is a netting-off calculation in order to restore the parties back to the proper position.
- 7.23 In this case, though, Ofcom is not proposing that BT should repay the full amount that TalkTalk paid. Rather Ofcom is proposing that TalkTalk are repaid the overcharge (above the proper amount). (For the avoidance of any doubt TalkTalk is not arguing that either). The concept of counter-restitution as developed in case-law therefore simply does not apply to this scenario because section 190 is clear in setting out a specific regime relating to Ofcom’s powers relating to repayments of past overcharging (above the proper amount). In other words, by only requiring the repayment of the overcharge s190 already takes into account the netting-off principle.
- 7.24 We gather from §377 and §378 that BT considers Ofcom should perform some kind of netting-off calculation between different services and possibly even between different economic markets (as an essential part of BT’s proposed counter-restitutionary approach). Such an approach would clearly be incompatible with, for example, the provisions of Condition HH3 which requires:
- that each and every charge offered, payable or proposed for Network Access covered by Condition HH1 is reasonably derived from the costs of provision [emphasis added]*
- 7.25 The condition, in other words, is clear that each charge must be assessed on its own and any overcharge is on the basis of each charge. The netting-off suggested by BT has no role at this level.
- 7.26 BT also advances arguments about a compensatory approach. Again, there is no need to consider these because the provisions of s190 are clear and do not require an assessment of actual economic harm. There is also no need to investigate why this might be the case (the words are clear on their face) but the Tribunal provides one excellent reason in §326 of the PPC Judgement:
- Economic harm and breach of the cost orientation obligation are, therefore, two sides of the same coin. If prices are not orientated, then potential purchasers of PPCs are very likely to be damaged*

³⁸ Spence v. Crawford, [1939] 3 All ER 271

7.27 In short, BT's case appears to be premised on reading-in to the Communications Act some rules which BT has chosen from other areas of law which it believes (wrongly) will enhance its position. There is no justification for this reading-in exercise³⁹ and the suggestions advanced by BT do not help their case in any event.

7.6 Court of Appeal case

7.28 We note that BT seeks to rely on submissions it has made to the Court of Appeal in relation to PPCs. It is not open to BT to rely on those submissions here, for two reasons. First, those are separate proceedings. TalkTalk (who is a party to this dispute) is not currently a party to the Court of Appeal proceedings and it has not seen BT's submissions. Secondly, PPCs are different from the Ethernet services under consideration here and while there may be some similarities there are also notable differences. For the avoidance of doubt, we are not commenting on those differences; our point is simply that if BT has arguments to make in this dispute, it must make them here, and apply them to the facts of this dispute; it may not seek to rely on something said elsewhere. Therefore, Ofcom cannot take into account any arguments that BT has not raised in full in this specific dispute and in the context of the particular circumstances of this dispute.

7.29 Without prejudice to the need for BT to fully raise its concerns in this dispute, we do offer some comments on them below.

7.30 BT seem to suggest (§358) that because BT cannot complete the dispute resolution process in 4 months then Ofcom has no jurisdiction to use its dispute resolution powers. This is plainly wrong. Firstly, Ofcom may take more than 4 months in exceptional circumstances (and these are clearly exceptional circumstances since the dispute is complex and BT has been slow in providing data). It is particularly surprising that BT has advanced this argument when the cause of much of the delay is BT not providing accurate figures and BT appealing opening of decision. To not allow complex dispute to be resolved using dispute resolution would be rob Ofcom of critical powers that are needed to meet its duties. It was not the purpose the Act to restrict the use of dispute resolution powers.

7.31 BT's claims that Ofcom did not consider certain factors (§365) is misplaced. For example:

7.31.1 Ofcom considered the effect on competition and investment (albeit not properly)

7.31.2 When BT refers to the need for an 'economic analysis' it is not clear what it means. However, Ofcom made its decision by reference to the economic impact (albeit not properly).

³⁹ Certainly the 4Eng case (4Eng Ltd v. Harper and ors [2009] EWHC 2633 (Ch)) is no authority for the argument advanced by BT in §374; that case concerns fraudulent misrepresentation and is nothing whatsoever to do with Ofcom's powers under s190 of the Act.

- 7.31.3 It is absolutely proportionate for Ofcom to intervene. For example (using the tests BT lays out at §367): it has a legitimate aim (ensuring economic efficiency); it will be effective in meeting its aim; and, it is targeted and necessary

7.7 Compliance investigation

- 7.32 We believe that Ofcom should consider investigating BT's compliance in a number of regards:

- 7.33 First, maintenance of accurate cost records where BT has accepted that its records were inadequate (§ES25, §226) and where BT has almost suggested that Ofcom investigate:

It might be said that the errors in the published numbers should have been discovered earlier. Clearly it would have been better had they been but they were not. In truth the calculation of the DSACs received too little attention by BT ... (ES25)

Ofcom ought not to be effectively fining BT multi-million pound sums for having made an error in the published accounts - it has other powers it could and should use for such a purpose. (ES24c)

- 7.34 Second, meeting its cost orientation obligation (HH3). Assuming that Ofcom find that BT has set prices too high then it should consider opening an investigation into BT's compliance with its cost orientation obligation and whether BT should be fined for its contravention. Ofcom should also consider whether BT has taken the appropriate steps in order to fulfil its obligation to demonstrate that it has complied with its obligation (as it is clearly required to do) by for instance developing an implementing a robust compliance management approach.

7.8 Ofcom's duty of transparency

- 7.35 Though not directly pertinent to this dispute, BT claim that (if Ofcom determine the dispute in line with its draft) then Ofcom have failed in its duty to be transparent since the obligations on BT were not made clear. For instance, BT says:

If Ofcom nevertheless applies that approach in its final determinations of these Disputes, Ofcom will be acting contrary to its duties as regulator, including the requirements of transparency ... (§22)

To apply Condition HH3 now in this way is wrong and breaches the law on certainty, transparency and consistency. (§304)

[Ofcom must] ensure that the obligations which are placed on CPs (including BT) are sufficiently clearly stated so that those CPs know unequivocally what their rights and obligations are before they commit themselves to any course of action. (§28.2)

- 7.36 We consider that BT's claim is unfounded for a number of reasons (which are similar to those as to why BT's claims regarding lack of clarity are unfounded – see §§§ above):

- 7.36.1 BT has previously stated that it had complied with its obligations (implying that it understood what the obligations were)
- 7.36.2 BT obligations were clearly laid out in HH3 and some guidance was provided in the 1997/2001 Guidelines
- 7.36.3 BT never asked Ofcom for guidance or clarity
- 7.36.4 That the obligation was not fully precise was something that BT supported (since it was light touch and allowed BT flexibility)
- 7.36.5 It is not unusual for regulations to not be fully specified. Indeed many other regulations are described in general rather than precise terms
- 7.36.6 It would be inappropriate for Ofcom to micro-manage BT through highly precise regulation and indeed BT has consistently argued against micro-management and in favour of 'light-touch' regulation that allowed BT flexibility.

7.9 Other

- 7.37 We note that BT suggests that cost minimisation incentives can be improved by allowing pricing flexibility (§207.2). This is false. See TalkTalk submission §3.37ff.
- 7.38 BT has previously argued that WES/BES products should have a higher allowed WACC since they were higher risk. Ofcom in the Draft Determination invited BT to provide evidence to justify this (see Draft Determination §9.77). BT has not provided the required evidence and instead at §341.2 says:

Given the risks Openreach was taking and the great efforts it was making to meet demand it would be appropriate for it to be allowed a higher than normal return in the early years.
- 7.39 The level of effort is irrelevant to risk and there is no evidence to suggest a higher risk – it is a mere assertion. BT provides no relevant evidence to suggest that a higher WACC is warranted. As we pointed out in our response (at §3.136) the RoBT WACC that is allowed is probably generous to BT anyway. BT has also indicated that there was high risk since it was making large investments in EBD and EAD (§338.4). However, these costs and their risks are not relevant to the cost of WES/BES services.
- 7.40 We note that BT has redacted much of the information in its submission including information regarding 2006/07. We are puzzled as to why this information might be considered commercially confidential. Ofcom must challenge robustly BT's claims regarding confidentiality.

8 Annex: Sensitivity of WES/BES unit costs to demand

- 8.1 The sensitivity of unit FAC/DSAC costs to (unpredicted) changes in volumes depends on the nature of costs. We describe below how the sensitivity of costs depends on the nature of the costs using the example of all WES/BES products.
- 8.2 Some of the costs will be variable to the volume of WES/BES product demand (e.g. customer support, Ethernet equipment) so that a (say) 40% increase in demand will result in a 40% increase in total cost and thus not result in a change in unit cost.
- 8.3 Some of the costs will be fixed but dedicated to WES/BES products. The wholesale systems and product management costs will tend to be fixed (or largely fixed) and are dedicated to WES/BES. This means that a 40% increase in demand will result in no change in total cost and thus a 29% decrease in these unit costs.
- 8.4 Some of the costs will be mostly fixed and shared between multiple products (i.e. fixed and common costs). Duct and fibre costs are the key type of costs that have these characteristics. Using the example of duct, a 40% increase in the demand in WES/BES will have the following effects (it is shown in the table below):
 - 8.4.1 WES/BES accounts for less than 10% of BT's total duct volume. Using conservatively a 10% assumption, a 40% increase in demand for WES/BES will result in a 4% increase in demand for duct (from 100 to 104)
 - 8.4.2 Duct costs are mostly fixed though slightly variable. Assuming a CVR of 0.10 the 4% increase in total duct demand will result in a 0.4% increase in total duct cost (£4,000 to £4,016)
 - 8.4.3 The WES/BES allocation of the total duct costs will increase from 10% to 13.5% (= 14 / 104)
 - 8.4.4 The combination of these two effects (small increase in total duct costs and large increase in allocation of cost to WES/BES) mean that the total allocation of duct cost to WES/BES rises almost in proportion to the volume increase and the unit WES/BES cost only falls slightly (-3.5%) (from £40 to £38.6)

Impact on WES/BES duct unit cost due to higher volume

Base case	WES/BES	WES/BES % total	Total
Volume	10	10%	100
Cost	£400	10%	£4,000
Unit cost	£40.0		
Higher volume WES/BES case			
increase in WES/BES demand	40%		
increase in total duct volume	4.0%		
CVR	0.10		
increase in total cost	0.4%		
Volume	14	13.5%	104
Cost	£540.6	13.5%	£4,016
Unit cost	£38.6		
Change in unit WES/BES cost	-3.5%		

- 8.5 Therefore, for costs such as duct and fibre the unit duct cost for WES/BES is not highly sensitive to demand – a 40% increase in volume only results in a 3.5% reduction in unit costs. This dynamic happens because though the total duct cost is mainly fixed, an increase in volume of WES/BES attracts an increased allocation of the total cost.
- 8.6 An examination of the WES/BES costs in the RFS indicates that:
- 8.6.1 About 35% of the cost is support / general management that will be mostly variable and shared fixed
 - 8.6.2 About 35% of the cost is duct and fibre which is shared and fixed
 - 8.6.3 About 20% of the cost is transmission which is variable
- 8.7 Thus overall WES/BES unit costs are not highly sensitive to demand since few of the costs are fixed and dedicated to WES/BES.
- 8.8 In the case that increased WES/BES demand is substitutional (e.g. from PPC) then the effect on unit costs will be even less.