Ethernet Historic Charges Dispute

BT's response to BSkyB, TalkTalk Group and Virgin Media's Dispute References

Non-Confidential

20 May 2011

Executive Summary

1. This document provides BT's response to the allegations made by BSkyB, TalkTalk Group and Virgin Media concerning historic Ethernet charges.

2. BT contends that it is neither appropriate nor lawful for Ofcom to use its dispute resolution powers in this instance. The essence of the complainants' allegations is that BT's Ethernet charges were not consistent with BT's regulatory obligations. This lack of compliance has not been demonstrated or upheld by Ofcom therefore BT contends that there is no basis for a dispute.

3. Should Ofcom (wrongly) consider it appropriate to proceed to determine the dispute it should consider a number of issues in assessing historic compliance. In particular, it would be wholly wrong to assume that Ofcom's approach to resolving the PPC dispute and/or the CAT's Judgment on the subsequent appeal in any way support a read across of a rigid approach to compliance based on comparing observed revenues with observed DSACs at a granular service level.

4. The central tenet of the complainants' argument is that BT's historic Ethernet charges are not cost orientated. Regardless of the Outcome of BT's challenge to the CAT's Judgment, there are a specific set of market circumstances that Ofcom needs to take full account of in assessing historic compliance with the SMP remedy in this case that were simply not present in the PPC case.

5. It is relevant to note that prices have to be set on the basis of prospective costs and in this nascent market we faced considerable risk and uncertainty. As outlined in detail in our defence BT took all reasonable steps at the time when setting Ethernet prices to ensure that they were cost orientated. BT also took action on an on-going basis to monitor its continued compliance and took steps to revise prices before they became misaligned from costs.

6. We set out how, in the period to 2007, we had taken steps to demonstrate to Ofcom that our charges were cost orientated. In particular, and significantly, this included a response to specific questions asked by Ofcom under a s.135 notice for BT to set out how its charges were consistent with the basis of charges obligation HH3. We fail to see how the data presented to Ofcom at this time and the engagement we had around our pricing strategy and portfolio evolution did not in itself amount to us satisfying Ofcom that our charges were derived in a manner consistent with the SMP remedy. We therefore submit that we demonstrated up to this date that our prices were cost orientated.

7. We further outline the analysis BT undertook in 2008 in order to reset its Ethernet charges as it became apparent that some charges were in danger of becoming misaligned with costs. These steps included detailed and close consultation with Ofcom. We further note that BT sought to reduce prices in November 2008 and applied for a waiver of the standard 90 days notification period. A number of CPs objected to the waiver request, including notably Virgin, who argued that proposed prices may be too low despite the fact that they are now assert prices were too high.

As a result the date of the price reductions was delayed to allow the full 90 days notification period.

8. That BT had taken appropriate steps to comply with its cost orientation obligation is affirmed by Ofcom's own subsequent actions in the 2009 leased lines charge control when Ofcom considered that only BT's BES1000 rental prices required a start price adjustment. It seems inconceivable to us that Ofcom would commence a charge control with charges that did not comply with the basis of charges obligation, HH3.

9. BT further contends that it is not appropriate to use DSAC ceilings as a mechanistic tool either for the assessment of cost orientation or as a proxy for cost orientated charges. Other factors are relevant.

10. By considering the overall FAC of the portfolio, BT was looking at ensuring prices were reasonably derived from the long run incremental costs of provision plus an appropriate mark up for the recovery of common costs plus an appropriate return. We would note that:

    (a) the observed ROCE numbers from the RFS suggest that at the time the condition was imposed in 2004, overall ROCE on the portfolio was low. BT was in start-up phase and BT priced to grow the market and ensure full cost recovery in a reasonable time period against a backdrop of considerable uncertainty of future demand; and

    (b) while Ethernet services have proven to be highly successful for both the CPs and Openreach this was not always guaranteed and the scale of demand was incredibly uncertain. Indeed the forecasts of demand for Ethernet services made at the time the Ethernet services were launched and for several years thereafter were for volumes significantly below those actually experienced.

11. This pricing strategy was therefore risky and BT assessed observed ROCEs in that context:

    (a) BT could not rely on service level DSACs to assess cost orientation and in fact did not produce them until Ofcom required BT to do so much later on;

    (b) as such, we would note the observed RFS data showed us returns were not excessively high even by reference to relevant regulatory WACC in 2004/5 and 2005/6; and

    (c) notwithstanding this, BT did not believe that single year returns above the level of the likely regulated WACC would raise concerns given the weight that Ofcom itself had been attached when imposing the SMP remedy to the riskiness of investments and ensuring new products recovered costs over time

12. In any event, any reliance now upon DSACs has to be on actual DSACs and the published figures need to be adjusted to take account of errors that BT has discovered in its calculation of published DSACs for Ethernet services. In fact, even without any

adjustments to DSAC to cater for this, BT's charges for the AISBO market as a whole did not consistently exceed the DSAC ceiling other than for intermittent odd years. This can be seen from the Disputing Parties own material; there was no period of two consecutive years in which DSAC is exceeded. If one incorporates the adjustments, this should show that, for the AISBO market as a whole, BT's charges were below DSAC.

13. It is clearly further appropriate in this case to aggregate rental and connection charges. These elements can never be bought in variable proportions: they are only ever purchased in fixed proportion to each other. In short, they are one purchase unit in a single defined market. As such, BT was and is entitled to have regard to this combination in demonstrating its cost orientation compliance. This has been recognised by Ofcom in its approach to considering start price adjustments in the 2009 LLCC. Ofcom has also followed this approach more recently for example, when responding to BT's concerns around the operation of the basis of charges condition in both the WLA and WBA market reviews.

14. We also set out below the legal errors that would occur if Ofcom were to follow the substantive PPC judgment.

BT
20 May 2011

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1. Introduction

1. This response ("**the Response**") forms BT's formal response to (a) BSkyB's and TalkTalk Group's dispute reference of 27 July 2010[1] and (b) Virgin Media Limited's undated dispute reference[2]. These dispute references will be referred to as "**the Dispute References**" (and where necessary by reference to the respective instigators). The three instigators are referred collectively to as the "**Disputing CPs**".

2. BT should make clear from the outset that:-

   i. this Response is made without prejudice to BT's request for permission to appeal to the Court of Appeal[3] the two judgments of the Competition Appeal Tribunal in the Private Partial Circuits case[4], namely the preliminary issues judgment, [2010] CAT 15,[5] and the substantive judgment [2011] CAT 5.[6]; and

   ii. simply because BT has failed to comment upon any particular contention put forward by the Disputing CPs should not be taken as BT's acceptance of that contention. BT was does not intend to overburden the dispute resolution process by a point by point rebuttal of the Disputing CPs' material and unless specifically accepted, it should be assumed BT challenges the material and conclusions.

3. BT understands, based on inferences from Ofcom, that Ofcom may be pre-disposed simply to "read across" what Ofcom believes to be the underlying principles decided by the Preliminary and Substantive PPC judgments in determining the Dispute References. BT would make two key points:

   (a) pending the outcome of the appeal process, BT contends that, if Ofcom adopts such an approach, Ofcom will commit serious errors of law; and

   (b) in any event, the circumstances of the Dispute References, are substantially different to the PPC case. Accordingly, even if the Preliminary and Substantive

[1] Entitled "*BT Charges for Backhaul Extension Circuits – Request to Ofcom, pursuant to Section 185 of the Communications Act 2003, to resolve a dispute between* [the Disputing CPs] *and BT*". The reference covers charges for Backhaul Extension Services ("**BES**") for the period 24 June 2004 to 31 July 2009 and is supported by a report dated 23 July 2010 from RGL Forensics.

[2] Entitled "Reference of a Dispute to Ofcom by Virgin Media Limited under s185 of the Communications Act 2003" in respect of BES and Wholesale Extension Services ("**WES**") for the period 1 April 2006 and 31 March 2009.

[3] Initiated by BT's Application for Permission to Appeal, dated 26 April 2011

[4] "**The PPC Case**": CAT Appeal number: 1146/3/3/09: http://www.catribunal.co.uk/237-5136/1146-3-3-09-British-Telecommunications-Plc-.html

[5] "**The Preliminary Issues PPC Judgment**"), 11 June 2010, : http://www.catribunal.co.uk/files/1146_BT_Judgment_CAT15_110610.pdf

[6] "**The Substantive PPC Judgment**"), 22 March 2011, : http://www.catribunal.co.uk/files/1146_BT_Judgment_CAT5_220311.pdf

PPC Judgments were to be subsequently upheld, Ofcom must still recognise the substantive differences in the Dispute References to the PPC case.

4. BT will in this Response set out its contentions, concerning the errors of law identified in the Preliminary and Substantive PPC judgments concerning Dispute Resolution, cost orientation and remedy. It will also separately set out BT's contentions as to (i) the substantial differences between the Preliminary and Substantive PPC judgments as these Disputes and (ii) why BT's charges, whether historic or current, for its AISBO (including WES and BES) products, are both compliant with BT's regulatory obligations and fair and reasonable as between BT and the Disputing CPs.

5. In the Response, references to sections are references to sections of the Communications Act 2003 unless the contrary is indicated.

2. Dispute Resolution

2.1 Introduction

6. Despite the observations in the Preliminary and Substantive PPC Judgments, BT contends that Ofcom has no statutory or other basis to consider and resolve, using its dispute resolution powers, disagreements that relate to historic issues (particularly historic disagreement about charges (whether or not based on an allegation or finding of a failure to comply with an SMP condition)) or to use its dispute resolution powers to determine a compliance based allegation of an historic failure to comply with an SMP condition and/or direct the payment of compensation or other financial remedy as a result of that failure.

7. The Disputing CPs put the 'dispute cart before the compliance horse'. Each of the disagreements raised with BT pre-supposes (wrongly) that BT has failed to comply with an SMP condition. Based on this misconceived presumption the Disputing CPs sought, prematurely, to negotiate a (restitutionary) repayment and thereafter, inappropriately sought to have the 'disagreement' resolved as a dispute by Ofcom. The 'cart is before the horse' as for there first to have been a compliance failing, about which to disagree, Ofcom must have first made a finding that BT was in breach of an SMP condition and no such finding has been made.

2.2 The nature of dispute resolution

8. The basis of Ofcom's jurisdiction to resolve disputes raised by Communications Providers ("**CPs**") is the EU Common Regulatory Framework ("**CRF**"), in particular Article 20 of the Framework Directive ("**FD**") and Article 5(4) of the Access Directive ("**AD**"). The jurisdiction to resolve such disputes (i.e. disputes raised by CPs) is the Dispute Resolution ("**DR**") regime. The meaning and scope of the DR regime is

ascertained from, not only the wording of the FD and the AD, but also the context and the objectives pursued by the FD and the AD as part of the CRF as a whole.

9. The CRF, on its true construction, precludes the use of the DR regime to resolve a dispute that is historic in nature. The clear objective of the DR regime, in contrast to other mechanisms, is to provide a speedy resolution of a current dispute between CPs, i.e. disputes about the 'here and now' and not historic matters.

10. The trigger for invoking the DR regime is that commercial negotiations must have failed.[7] Only where commercial negotiations about the current basis for access and / or interconnection have failed, can the aggrieved party call on the National Regulatory Authority ("**NRA**") to resolve the dispute using powers under the DR regime. It is inherent in the overall context and objectives pursued by the CRF and the various mechanisms for resolving disputes that historic disagreements, in particular issues based on an allegation of historic non-compliance with an SMP condition, fall outside the DR regime.

2.3 Dispute or compliance complaint

11. The Dispute References are not, in function, a request for Ofcom to resolve a dispute between BT and the Disputing CPs about the correct amount of the charge for Network Access. Rather, they are a compliance complaint that BT's historic charges failed to comply with Condition HH3.1 ("**the Condition**"). This premise is clear from the Sky & TTG Dispute Reference,

> "*Ofcom has made* [a] *finding that BT has significant market power ("**SMP**") in a number of different markets in which it supplies other communications providers, including the market(s) in which it provides BES products.*[...] *As a consequence of these finding*[s], *Ofcom has imposed SMP-related regulatory conditions on BT ("**SMP Conditions**"). These SMP Conditions fix BT with various obligations, including a 'Basis of Charges' obligations (Condition HH3), effective from 24 June 2004, which required BT to "*secure, and *[be]* able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition HH1 is reasonably derives from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed*"[...]..."*[8]
>
> [Emphasis as per the BSkyB & TTG Dispute Reference]

[7] Recital 32 to the FD, and Recitals 5 and 6 to the AD.
[8] § 3, the Sky and TTG Dispute Reference

12. The Virgin Dispute Reference, is very similar in tone and function, for example,

> "***(e) <u>Virgin's complaint</u>***
>
> *20. Virgin believes that BT has significantly overcharged for local end rental when compared against the <u>relevant LRIC ceilings specified in BT's Regulatory Accounts</u> for the following services…*"
>
> [Emphasis added]

13. Having made that premise clear, the Disputing CPs then clearly make a compliance complaint that BT's historic charges for its BES product are incompatible (that is non-compliant) with the Condition. For example,

> "*Throughout the Relevant Period, BT was required to set its charges for BES in accordance with the Condition (the "**Relevant Charges**"). In the submission of the* [the Disputing CPs]*, <u>BT failed to do so. Its charges were significantly above what it was entitled to charge in accordance with the condition</u>. As a consequence, the* [Disputing CPs] *have been overcharged for BES.*"[9]
>
> [Emphasis added]

and,

> "*Accordingly, the* [Disputing CPs] *contend that BT's Relevant Charges have been higher than <u>permitted by the Condition</u>; and the* [Disputing CPs] *therefore request that Ofcom assesses the extent to which they have been overcharged.*"[10]
>
> [Emphasis added]

14. The 'disagreement' is clearly about the amount that BT should repay the Disputing CPs for the alleged historic overcharge. However, this presupposes that the premise for the disagreement – that BT had breached the Condition, by not ensuring that its charges were cost orientated – is correct (it is not). As such, no dispute may exist, as a pre-requisite for such a dispute (and the use of the DR regime in this case) is that Ofcom, following a compliance investigation, must have found BT in breach of its historic obligation to comply with the Condition.

15. Even if Ofcom were to make a compliance finding that BT's historic WES and BES charges were not cost orientated, and a disagreement between BT and the Disputing CPs were to arise as to the level of repayment, it would still be inappropriate for Ofcom to open a dispute. The disagreement, relating not to an issue about which Ofcom has jurisdiction under section 185 of the Communications Act 2003 i.e. a dispute about

[9] § 6, the Sky and TTG Dispute Reference
[10] § 12, The Sky and TTG Dispute Reference

access or interconnection, but rather a dispute about the type and quantum of compensation appropriate for that (alleged) compliance breach. The assessment of compensation is arguably a matter for the Courts, subject to Ofcom granting permission.

2.4 Conclusion

16. There being no true dispute capable of resolution under the DR regime, Ofcom must close the dispute. Should Ofcom (wrongly) consider it appropriate to proceed to determine the dispute the remainder of the Response demonstrates that BT's historic charges complied with the Condition.

3. Cost Orientation

3.1 Introduction

17. This section of the Response explains what cost orientation is, how it applied in the AISBO market during the Relevant Period, how it applied to the BES and WES products and why BT's charge were compliant with the Condition.

18. In this section, BT will not deal with the correctness or otherwise of the observations on cost orientation made in the Substantive PPC Judgment (though as indicated above this is without prejudice to BT's application for permission to appeal or any subsequent appeal). BT will deal with the specific issues relating to that in section 4 below. Instead, this section 3 will set out the substantial differences between the PPC case and why, regardless of the rights or wrongs of the Substantive PPC Judgment, BT nonetheless can clearly demonstrate that its BES and WES charges were cost orientated.

19. In particular BT makes the following key points by way of introduction:-

    (a) the cost orientation obligation provides latitude and flexibility as to its application;

    (b) that latitude can only properly be considered in the context of the particular market to which the cost orientation obligation applies. Thus, whatever the position was in respect of BT's PPC pricing, the same analysis cannot mechanistically be applied to the very different situation with AISBO market products;

    (c) for example the market and the products were relatively new and there was a lack of historic data;

(d) despite those limitations, BT's returns were well within acceptable bounds, for example of ROCE;

(e) from 2006 onwards BT was specifically considering its charges in conjunction with Ofcom. For example, BT was specifically requested by Ofcom in 2007 to demonstrate that BT's charges in the AISBO market were cost orientated and BT did just that. Ofcom can clearly be taken as being satisfied that BT had demonstrated that BT's charges in the AISBO market were cost orientated;

(f) only during the course of 2008 did the 'figures' start to raise concerns that prices might be beginning to become 'out of line' with costs. At that point BT sought to adjust it prices. This provides compelling evidence that BT was indeed seeking to secure that its AISBO charges were cost orientated. Indeed, it is heavily ironic (and completely unfair in the context of this DR process) that BT was in part prevented from reducing its prices for WES and BES products immediately because of objections from Virgin Media, including that certain of the price reduction would take the notified charges below cost. As a consequence, BT sought from Ofcom a waiver to the regulatory notification period. Ofcom published a statement: "Waiver of BT's price notification requirements for certain of BT's WES, WEES and BES prices"[11] on 30 January, following a consultation. This Statement sets out the history to the waiver and the views of the interested parties, including VM.[12]

(g) further, when in 2008 and 2009 Ofcom subsequently reviewed the AISBO market and imposed a price cap upon the AISBO products, Ofcom did not, with one exception, require BT Openreach to make decreases in the starting prices for the price caps. It is inconceivable that Ofcom would have done this unless Ofcom was satisfied that BT's prices for WES and BES were properly cost orientated.

20. BT would make a further introductory point. BT, throughout, has sought to ensure that its prices in the AISBO market were cost orientated. In the following sections, BT will set this out in some detail, following a chronological sequence. This is crucial as the context in which BT sought to achieve this did change over time. For example, as set

[11] http://stakeholders.ofcom.org.uk/binaries/consultations/btprice/statement/Draft_Waiver_Statement_Jan_1.pdf

[12] At paragraph 3.17 iii) "*…COLT and Virgin Media, who did not consider Ofcom had properly demonstrated the consent to be objectively justifiable and proportionate. They argued that some of the new prices are perceived as being below cost, opposed the consent and demanded that Ofcom investigate these prices before granting any consent. Virgin Media also argued that the imposition of the transparency obligation in the BCMR Statement, including the 90 days notice period, supports other conditions imposed on BT and that therefore the consideration of whether the new prices comply with BT's cost orientation obligation is relevant to this review about the waiver.*" [emphasis added]

out in paragraph 19(e) above, in 2007 BT clearly demonstrated to the satisfaction of Ofcom that its prices were cost orientated, but, as set out in paragraph 20(f) above, in 2008, BT sought to secure compliance by actually altering its prices.

21. However, if and insofar that BT is now lawfully (again) being required to demonstrate to Ofcom that its prices were cost orientated[13], BT is entitled to use all information now available to demonstrate its compliance. This material is considered in section 3.8 onwards.

3.2 The latitude inherent in a Cost orientation obligation

22. Ofcom concluded in the 2004 LLMR that it was appropriate to impose a cost orientation obligation in respect of the AISBO market (Condition HH3). BT would reiterate three key points about this obligation:-

(a) Cost orientation is specifically meant to involve a lighter degree of regulatory control than price charge caps or other price control regulation. As was noted by the ECJ in *Arcor*, cost orientation has to permit,

> "*a reasonable return from the setting of these rates in order to ensure the long-term development and upgrade of existing telecommunications infrastructures*".

As discussed in section 3.3 below, in an innovative and developing market, such as the AISBO market, BT should be accorded a considerable degree of discretion in how it demonstrates that it is complying with its cost orientation condition.

(b) No test is prescribed as to how exactly BT was to demonstrate cost orientation. BT is therefore not restricted in the material upon which it can rely to demonstrate compliance and is, again, accorded a considerable discretion.

(c) The obligation related to products in the AISBO market. BT considered the obligation solely in respect of that market. The products referred to in the Dispute References all relate to this market. There is no question in this case of BT seeking to aggregate charges across two separate markets as was the situation in the PPC case and, in clear contradistinction to the PPC case[14], there is no question of "*conflating distinct schemes of regulation*".

[13] In particular BT contends that, insofar as Ofcom has already requested information to demonstrate this (for example in 2007) and did not raise concerns – in short has already been satisfied once, Ofcom cannot now seek retrospectively to require a re-opening of this. However, whilst BT maintains this point, BT clearly can demonstrate cost orientation.

[14] See §§ 225-226 of the Substantive PPC Judgment.

23. Further, even taking a narrow interpretation of the Condition (which BT suggests in Section 4 below is wrong) there are at least four parameters by which the cost orientation obligation must be judged and which provide the dominant provider a significant degree of latitude in demonstrating that a charge is cost orientated. These four parameters are:

- that the charge only has to be "reasonably derived" from the costs of provision
- that the costs of provision have to be based not upon immediate costs but upon a "forward-looking" and "long-run" incremental cost
- that BT is allowed is an "appropriate mark-up" for the recovery of common costs for the provision of network access to which the charge relates which in turn raises the issue of the exercise of judgment over the attribution and level of common costs for any given product
- that BT is allowed an "appropriate return" on the capital employed which again requires an exercise of judgment in respect of the risks involved in developing the market, for any given product

24. In considering what material BT is entitled to rely upon in order to demonstrate that each charge is so reasonably derived, each of these parameters must be considered, and can only be considered, in the specific context of the market to which they relate - in this case the specific circumstances of the AISBO market in 2004 and onward. To do otherwise (for example by mechanistically adopted approaches taken in other markets – such as the PPC market) would completely negate the latitude expressly allowed within cost orientation condition.

25. BT would add, the purpose of a cost orientation obligation is to encourage the dominant provider to price in a way that it would do if it were operating in a competitive market. Accordingly, BT's cost orientation obligation in the AISBO market cannot be divorced from the nature of and effect upon the competition in that market. In particular, it requires some consideration of the economic circumstances of the market. BT criticises the conclusions made by the CAT in the Substantive PPC Judgment in section 4 below.[15] However, in any event, without an analysis of what is happening in the market, it is impossible to gauge whether BT is making a sufficient return on capital to compensate for the risk to investments for the relatively innovative products introduced into that market. For example, far from BT's prices discouraging activity in

[15] In particular BT criticises the conclusion by the CAT that, contrary to Oftel's own guidelines on cost orientation published in 1997 and 2001 (Guidelines on the Operation of Network Charge Controls), the need to show some form of economic harm is not a pre-requisite to a finding of a breach of a cost orientation condition: see §327 of the Judgment.

the market, there is very clear evidence that demand continually outstripped forecast estimates.

3.3 The AISBO market in 2004

26. Unlike the position with PPCs, AISBO services were not clearly identified and established when the cost orientation obligation was imposed in 2004. Thus in 2004 there was none of the "pre-existing history" of product development and cost allocation that had been established with PPCs[16].

27. Ofcom only identified and defined the AISBO services market in 2004: see for example §1.43 of the "*Review of the retail leased lines symmetric broadband origination and wholesale trunk segments markets*" dated 24 June 2004 ("**the 2004 LLMR**"). As Ofcom specifically accepted there were "*no existing obligations applying in relation to the wholesale alternative interface symmetric broadband origination ("AISBO") market*" in 2004: see §7.15 of the 2004 LLMR.

28. BT's products and the precise allocation of costs to this AISBO market were thus not at all established or clear-cut. As at 2004, the AISBO market was essentially a developing or nascent market. (Ofcom specifically acknowledges this: see e.g. §5.46 of the Leased Line Charge Control 8 December 2009). Moreover, Ofcom concluded (unlike, for example, the TISBO markets) that there was no need for different bandwidth classifications in the AISBO market: see for example §2.256 of the LLMR.

29. Indeed, it was specifically in the course of the 2004 LLMR that Ofcom required the provision of certain AISBO products. Thus, Ofcom gave a specific direction under Condition HH1 that BT was to provide specific LLU Backhaul services between 10 and 1000 M/bits in the AISBO market. Moreover:-

    (a) WES products were introduced in 2004 following a dispute over Short Haul Data services between Energis and BT, which was resolved by Ofcom; and

    (b) the specific requirement for BT to introduce mandated products was developed in 2005 during the negotiations leading to BT's undertakings under section 131 of the Enterprise Act 2002 ("**the BT Undertakings**").

30. These matters have highly important consequences for Ofcom's approach to whether BT's charges for AISBO products were cost orientated. BT will give two examples:

[16] In the instance of PPCs, Oftel had first considered PPCs in 2000 and giving specific draft Directions for BT to provide cost orientated PPCs in its December 2000 statement. PPC products, by 2004, already had an established history. For example, BT had prepared Regulatory Financial Statements ("RFS") for PPCs, clearly dividing-up the respective bandwidths and other component elements (including separate Trunk and TISBO services) since at least 2001. By 2005, there were clearly established PPC products and a body of data available to BT, from which it could make a more ready assessment of cost orientation.

i. BT is not seeking, and has not sought, to *"aggregate"* across two separate markets, which have two distinct (and, as the CAT, found entirely unconnected) obligations in that way that the CAT held BT had done for Trunk services and TISBO services. Accordingly the arguments considered and dismissed by the CAT on aggregation, at §§218-226 of the Substantive PPC Judgment, have no application to this case. Moreover, the underlying conclusion reached by the CAT as a direct result of BT's approach in that case (namely that BT had not demonstrated prices were cost orientated because BT had only ever considered cost orientation across two separate PPC markets[17]) has absolutely no parallel in this instance. BT has exclusively considered cost orientation in respect of the single AISBO market (and the products wholly within that market). The Substantive PPC Judgment was not considering this situation.

ii. Second Ofcom itself recognised that there should be a wider latitude where the market was developing and new services were being introduced. Thus at §7.58 of the 2004 LLMR Ofcom explicitly said,

> *"Ofcom confirms that all new services that are introduced into this market will also be covered by the same pricing rule … this does not however mean that BT cannot recover costs appropriate to new wholesale services. …"*

Ofcom expressly added in §7.59(iii)

> *"the new service falls within the market and the cost orientation obligation is applied, but there might be a range of prices which will be consistent with cost orientation given the uncertainty about the take up and future profitability of the service. In determining whether a charge is not cost orientated, Ofcom would consider whether the expected or achieved return on capital was excessive. In making this assessment Ofcom will need to take account of the risk of the new service failing and the lost investment that will result. …"*[18]

[17] See §251 of the Judgment

[18] BSkyB and TalkTalk, at §27 of their Dispute Reference, refer to the paragraphs in the 2004 LLMR preceding this material, but do not advert to this point. RGL Forensics, in their 23 July 2010 report, briefly comment on this at §2.8.1 -2.8.2. However, RGL make a completely different and false point. They seek to conclude that cost orientation is stricter in the case of AISBO products (and FAC should be exclusively used) because there was an express clause allowing Ofcom to exempt products from cost orientation. The conclusion drawn in §2.8.2 of their report is completely wrong because: (a) the clause allowing Ofcom to release products from the cost orientation obligation is not exclusive to this cost orientation obligation – it was a clause standard to all cost orientation obligations imposed by the LLMR, including established markets such as Trunk and TISBO; and (b) the observation about Ofcom releasing products from the cost orientation obligation was made by Ofcom in a completely different situation. §7.60 of the 2004 LLMR cross references the possibility of release from the obligation to the scenario in §7.59(ii); it specifically does not relate it to the scenario in §7.59(iii).

31. Accordingly, BT should be allowed a considerable margin of latitude when gauging whether its prices were cost orientated, certainly prior to the point when the market had become properly established, when considering the cost orientation on AISBO products. The AISBO services were in a new market, which required considerable upfront investment without any guarantee that demand would be at such a level that returns above costs (including costs of funding the investment) would be earned. In such circumstances, returns above the cost of capital can be expected when new services prove (as in this case) to be successful. Indeed, it was not until the third year of the four year control that returns began to exceed the WACC to any degree, with the ROCE in 2004/5 and 2005/6 averaging just over 12%.

32. In particular BT is entitled to take a number of factors into account when considering cost orientation including:-

(i) that there is an inevitable difficultly created by the lack of clearly established data. BT's ability to assess costs and project them forward is necessarily more restricted. BT inevitably has to judge its pricing going forward by reference to historic data. However, until there is several years of data allowing BT to obtain meaningful projections of volumes and revenue, BT cannot confidently predict whether and how it needs to change its prices[19].

(ii) BT is entitled to earn a higher ROCE given the developing nature of the market. Indeed as discussed below there was considerable uncertainty about the take up of the products offered and, as a result, estimates of volumes (including forecasts from CPs and analysts) were subsequently shown to be well below the actual out turn. This reinforces the very real and serious problems upon relying upon DSAC and DLRIC as the primary indicia of cost orientation.

(iii) certainly until the market had become properly established, BT is entitled to use as a parameter for gauging its cost orientation, indicia (including where appropriate DSAC) for the AISBO market as a whole. BT does not claim this should be the only parameter, but when there are unproven products on offer in essentially a nascent market, a clear cross check must be a comparison of prices against evidence for the market as a whole (including DSAC). For example, even on RGL Forensics' figures (which for the reason set out in this document are wrong), BT was not consistently above DSAC for the market as a whole for any two consecutive years.[20]

[19] Even therefore if the material was available (and in this respect see Section 3.4 below), BT cannot, be expected to rely upon whether its prices previously were below or above DSAC and DLRIC as key indicia to demonstrate cost orientation, until it can be sure that such data is reliable.

[20] See Figure 2, page 11 of the 23 July 2010 RGL Forensics' report

33. None of this should be taken as meaning that BT was not carefully monitoring its prices to try and ensure that they were cost orientated. It was precisely because BT was doing that, that:-

i. BT was able to satisfy Ofcom in 2007 that its prices were cost orientated (see section 3.6 below);
ii. BT took action to adjust it prices in 2008 (see section 3.7 below); and
iii. Ofcom only made a start price adjustment to one product in its 2009 Charge Control.

What it does mean is that a mechanistic application of DSAC ceilings to prices is simply not a viable tool in the developing AISBO market upon which Ofcom imposed the cost orientation obligation.

3.4 A fluid and developing market

34. As indicated above, in 2004 Ofcom considered a dispute referred to it concerning Short haul data and other services. Energis was requesting that BT should provide various products. Whilst rejecting some of the requested services, Ofcom held in a Final Determination dated 3 February 2004[21] that certain services fell in the AISBO market and should be provided by BT. These services were essentially the WES services. In short, these services were only "nascent" in late 2004. They were new products without any historic track-record upon which BT could base a clear assessment of cost orientation from, for example, the RFS.

35. Likewise in 2005, as part of the discussions and negotiations leading to the BT Undertakings [22], BT was required to give specific undertakings to product equivalence of inputs ("**EoI**") for Backhaul Extension services for September 2006 and by 30 September to "*launch a Wholesale Extension Backhaul Product which shall be offered on an Equivalence of Inputs basis*"[23]

36. Ofcom itself has acknowledged that the emerging nature of AISBO market meant that an overly granular focus was an inappropriate tool for cost orientation. Ofcom specifically prescribes the individual elements in respect of which information is to be published in the RFS. Such was the emerging nature of the AISBO market that:

(a) for the year to 31 March 2005 (the first year after the implementation of the cost orientation obligation in the AISBO market), in the AISBO market, BT was required only to publish a DSAC, DLRIC and FAC for SHDS (Short haul Data Services); and

[21] http://ictdec.org/en/regions/region_5/zone_177/database_12/decisions/10/en/10.pdf
[22] http://www.oft.gov.uk/shared_oft/monopolies/btundertakings.pdf
[23] See §§8 and 9 of Annex 1 to the Undertakings.

(b) for the year to 31 March 2006 (the second year after the implementation of the cost orientation obligation in the AISBO market) BT was required only to publish a DSAC, DLRIC and FAC for (i) Wholesale and LAN Extension Services in aggregate and (ii) Backhaul Extension Services in aggregate.

37. Accordingly the first year that Ofcom required (and BT actually prepared specific data for) DSAC and DLRIC for rental charges and connection charges at 10/100/1000 M/bits level was 2006/2007. Even then, BT was still publishing this for "Wholesale and LAN Extension Services"[24].

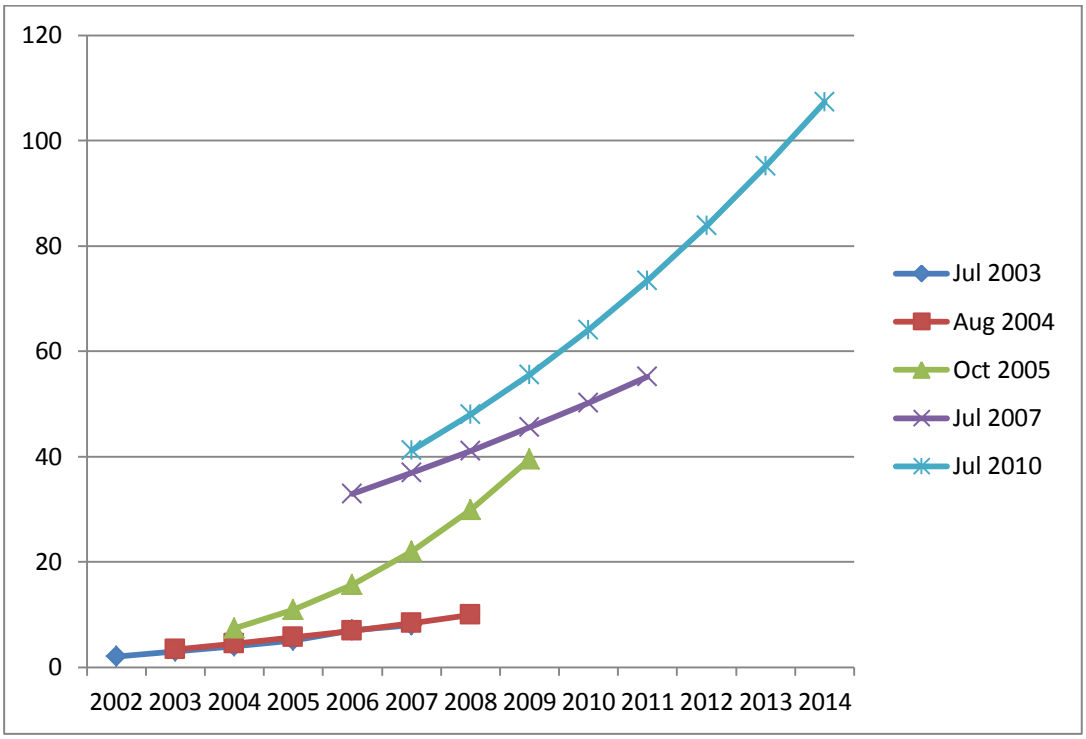
3.5 Demand forecasting in the developing AISBO market

38. As touched upon above, forecasting volumes – and thus precise unit costs -proved extremely difficult for this developing market. BT's volume forecasts had to be continually revised to keep up with increase in the demand for these products. This inevitably made forecasting the relationship of prices to costs difficult.

39. This was not a result of any error or lethargy on BT's part but is verified by an analysis of independent forecasters' predications. Below is a graph of the forecasts for the Ethernet market published by independent analysts. Each separate coloured line on the graph shows their forecasts for the market at the time specified on the right. Thus, it can be seen that after August 2004, the analysts had to substantively increase their forecasts in October 2005, revise them yet further upwards in July 2007 and significantly increase them yet again in 2010.

[24] BT would make a further point about the caveats that must be placed on the mechanistic use of DSAC. Since 2005/2006 reported DLRIC and DSAC have not been audited and are not required to be audited. This reinforces the point that BT could not be expected to consider DSAC to be the key indicator of cost orientation. Moreover, the fact that these figures were not audited, means that BT should not be criticised for adjusting figures as and when further information comes to light: see further section 3.11 below. The point made by the Disputing CPs that the cost of provision can only be derived from the RFS (see e.g. §2. 2.34 of the RGL report) is a nonsense – it is to be derived from the actual costs, not the unaudited originally reported ones as Ofcom acknowledged in the PPC case.

Figure 1: Graph showing the significantly revised forecasts of independent analysts



40. BT would make three points about these forecasting problems:

(i) it inevitably made estimating the precise price level that was required to keep BT's charges cost orientated extremely difficult. This was in part a result of, and certainly compounded by, the relatively new nature of the products in the market; the lack of established data for unit costs; and uncertainty about future levels of demand;

(ii) it demonstrates that, far from BT's prices in the AISBO market suppressing demand, demand significantly exceeded expectations, a point reverted to in section 3.13 below;

(iii) The fact that actual volumes out stripped forecast demand means that actual returns were higher than expected returns.

3.6 Events from 2004 to 2007

41. In this period, covering the first three years of the control, given (i) the developing nature of the market, (ii) the difficulties of forecasting, (iii) the lack of a body of historical data from which to make assessments, and (iv) the success of the services in the market place, it would not be surprising if BT returns were above the cost of capital. However, such context is precisely why there is deliberate latitude under the cost

orientation obligation and why a mechanistic test should not be applied. Ofcom itself cannot be taken as other than accepting this as demonstrated by the RFS (see section 3.4 above).

42. Further, despite these inherent problems, it is quite clear that BT was well within a range of returns acceptable for cost orientation. For example as Table 1 below shows for 2004/5 BT's ROCE was 8.8%, for 2005/6, 15.90% and for 2006/7, 20%. These are not returns which can be considered unreasonable under a regulatory regime which acknowledges the importance of providing confidence to invest in new services.

43. Moreover, BT was not considering this in isolation. BT provided Ofcom with a very significant level of information demonstrating BT's compliance with the Condition. BT worked very closely with Ofcom as BT's and Ofcom's respective strategy and policy in respect of AISBO / Ethernet products developed and BT altered its pricing and/or introduced new products. Much of this close working was as a result of the agreement of the BT Undertakings in September 2005 and the subsequent creation of the Openreach functionally separate line of business within BT.

44. This close working involved many meetings between BT and Ofcom during 2006, 2007 and into 2008. For example, BT's Karen Wray and Mike Hoban met with Ofcom's Gareth Davies, Steve Unger and Graeme Hodgson twice during the week commencing 21 August 2006, and agreed, that Ofcom and BT needed a strategic approach to Ethernet product pricing. Ofcom was particularly interested in the development of WES-A, WES-B and WEES product variants, to the extent that Ofcom asked BT to provide cost stacks for the pricing approaches that BT had developed at that time.

45. These close and regular working meetings included, amongst other things, BT presenting to Ofcom monthly reviews on BT's Ethernet Services, particularly in respect of BT's committed price review of its Ethernet products that took place during the third and fourth quarters of 2006/2007. These reviews included a discussion of BT's pricing strategy and the provision of pricing information[25]. Ofcom was also invited to attend BT's Ethernet Product Customer Forums.[26] This close working continued through 2007 as BT developed new AISBO services, in particular BT's EBD product and into 2008 with the publication of Ofcom's market review consultation document on 17 January 2008.

46. In addition to this close working between BT and Ofcom, two particular events, a complaint by THUS and Ofcom's preparation for the BCMR, resulted in the provision of additional detailed information to Ofcom. The information provided in respect of these two events is discussed below. What is clear is that BT shared a very considerable amount of financial and other information with Ofcom, including information about the

[25] For example the fifth Ethernet Road Map meeting on 4 September 2009

[26] For example the Ethernet Product Customers Forum on Monday 12 March 2007 which BT's records indicate was attended by Ofcom Neil Nasralla

basis on which BT had set its prices, and at no time did Ofcom raise any concerns or questions about BT's compliance with the Condition or how BT was approaching the task of compliantly setting its prices.

47. Moreover, Ofcom sought to outline a series of policy objectives that BT should endeavour to meet when setting its Ethernet charges, e.g. ensuring WES-A + WES-B should have a combined charge that was no greater than the charge for an equivalent WEES.

48. Ofcom gave no indication that BT's approach to assessing cost orientation was inappropriate or that Ofcom had any concerns as to whether BT's charges were compliant. In all the circumstances BT contends that it would be completely wrong (and indeed unlawful) for Ofcom now to find that BT was in breach of its cost orientation obligation HH3 for the period up to 2007.

3.6.1 The THUS plc complaint

49. On 11 May 2007 THUS made a "*formal complaint about the pricing and price structure of BT's WES/WEES Ethernet product portfolio, which* [THUS] *believe*[d were] *discriminatory and non-cost oriented, in breach of SMP conditions HH1, HH2 and HH3.*" THUS's complaint included detailed supporting information and argument. Ofcom requested BT's comments and observations on the scope of THUS's complaints. That response was provided in June 2007.

50. As part of its response BT provided 'cost stacks' for both its WES and WEES products and explained, shortly, why BT's charges were compliant with the Condition, commenting that "[w]*e believe this demonstrates that out prices are compliant…*". Subsequent to this letter, on 10 July 2007, Ofcom's Katherine Dinsdale, wrote to BT's Karen Wray by email, advising BT that it had decided, "*on the basis of administrative priority, not to open an investigation into THUS complaint about BT's Ethernet product portfolio.*" Ms Dinsdale further noted that,

> "*…Ofcom is in the process of reviewing the telecommunications market for retail leased lines, any other forms of retail business connectivity services (that it might be appropriate to include in the relevant market) and associated wholesale services (the "LLMR"). Having considered the THUS complaint carefully we consider that the issues raised are likely to be dealt with in the LLMR. Therefore, Ofcom does not consider it appropriate to open an investigation where the matters raised in the THUS complaint are likely to be dealt with under the LLMR…*"

51. This is clearly indicative that Ofcom had no significant concerns that BT's pricing for its WES and WEES products was obviously problematic. In addition, other obligations

needed to be balanced, for example the requirement not to unduly discriminate, and this required BES prices to be set in relation to WES prices. Further, it is noteworthy, that although the function of both the THUS complaint and the Dispute References are the same, i.e. seeking a decision from Ofcom that BT's charges are not compliant with the Condition, Ofcom decided to close the case.

3.6.2 Ofcom's request that BT demonstrate compliance

52. As part of its preparation for the review of the 2004 Leased Lines Market Statement (what subsequently became the 2008 Business Connectivity Market Review) on June 2007 Ofcom requested BT, under s.135, to provide a large amount of information about, amongst other things the AISBO market and particularly BT's WES and BES products. BT provided this information in stages throughout Q2 and Q3 and this information included details about the actual (2003/04, through to 2006/07) and forecasted wholesale service volumes (2007/08 and 2008/09) for WES and BES products. These responses also included a detailed submission explaining the market context for BT's submitted information.

53. Importantly, the information request required BT to, amongst other things,

> "*Provide calculations demonstrating how BT's current charges (i.e. those that come into effect on 14 June 2007, following the 90 day notice period) for each and every WES and WEES product complies with BT's ex-ante cost orientation obligation (HH3) imposed under the June 2004 LLMR.*"
>
> "*Provide calculations demonstrating how BT's proposed charges for each and every WES and WEES product, which came into effect on 2 December 2007 and 2 June 2007, complies with BT's ex-ante cost orientation obligation (HH3) imposed under the June 2004 LLMR.*"

and,

> "*Provide any information (other than that requested above) that BT considers is relevant to demonstrating that BT has satisfied its ex-ante cost orientation obligation (HH3) in relation to each and every WES and WEES product.*"

54. BT responded fully to these question and specifically wrote to Ofcom on 6 June 2007 (BT's Karen Wray to Ofcom's Graeme Hodgson) commenting,

> "*The title and some of the commentary included in* [Ofcom's letter of 5 June 2007] *implies that the information is requested in order to inform a Market Review, however it is our understanding that the information requested, and that we have supplied, is to be used in order to assess BT's compliance with Ofcom's SMP Condition HH3. It is for this purpose that the information is provided.*"

55. Subsequently, Ofcom asked a number of detailed follow up questions on 5 December 2007. These additional questions sought further information about BT's WES and BES products, including further information about BT's volume and cost information. BT responded to these additional questions, in detail, on 9 January 2008 and 8 February 2008. The provision of this information then led to a number of follow-up emails, between BT and Ofcom, to clarify Ofcom's understanding.

3.7 Events in 2008

56. As already indicated above, it was only by September 2008 that BT had two years of historic data in the RFS that split information down by specific bandwidths[27]. (Indeed, the figures were subsequently restated.) Moreover, as indicated in section 3.6 above, BT had previously supplied Ofcom with a significant amount of material from which to all intents and purposes Ofcom had been satisfied that BT's prices were cost orientated.

57. It was whilst reviewing the draft RFS for 2007/2008, that BT identified potential concerns with pricing. For example, BT identified that returns for the portfolio had risen above 20% in 2007/2008[28]. Specifically, because BT was concerned that its prices might have started to move away from the acceptable latitude allowed for cost orientation (i.e. "reasonably derived", "an appropriate mark-up" and a "appropriate return"), BT took steps to reduce its prices so, for example, BT's overall returns would fall to a more appropriate level.

58. Modelling what changes were required to which charges, across the AISBO portfolio, was complicated by the launch of further new products. In particular, BT was on the point of launching BT's new and lower priced EAD and EBD products[29] which were expected to be substitutes for the legacy products WES and BES.

59. BT had invested significantly in the EBD platform (£100's m) and as such, it was extremely important to BT that WES and BES products were priced both to ensure compliance and in a way that would encourage appropriate migration from the legacy products to the new platform.

[27] As Ofcom is aware these figures were in fact restated in the course of the latter part of 2008 and early 2009.

[28] It should be noted that, even though these returns were now above 20%, they still were very significantly lower than the level of returns for the Trunk market. A precise comparison is given in section 3.10 below. What this plainly demonstrates is that the present case is markedly different to and completely different scenario to the situation Ofcom and the CAT were facing in the PPC case. As such it reinforces the clear point that Ofcom can and must look at this case in the specific context of the AISBO market

[29] The EAD and EBD products enable multiple services to be carried across a fibre unlike WES and BES which require a separate fibre per service and were needed to mitigate the risk of and militate against the exhaustion of fibre capacity by the rapid growth in demand for Ethernet services.

60. In the normal course of events, price changes take several months from the point that a requirement for a price change is identified to the point that a change in price takes effect. For example, it may take two months or so to assess what the appropriate price change should be and to then have that proposed change "signed-off" by the necessary governance body. Only then can the price change be notified to industry, to take effect 90 days thereafter.

61. In this instance, the period became protracted due to the 'knock-on' portfolio implications created by EBD and were not notified until November 2008. At the time, BT wished to waive the regulatory 90 day notification period so that CPs (including the Disputing CPs) might obtain the benefit of the price reduction as early as possible. However, a number of CPs, including Virgin Media, objected to this waiver and raised a concern that charges were too low, insisting that the full notification period be observed, before the price changes came into effect. This resulted in CPs receiving only a one month benefit of the price change in the financial year 2008/2009.

62. A specific effect of the protracted introduction of the price change was that BT's reported returns for 2008/2009 were higher than they would have otherwise been, albeit lower than if BT had taken no pricing action.

63. Moreover, the close working between Ofcom and BT described in paragraphs 43 through to 46 continued throughout 2008/09.

64. BT contends that given all the circumstances and, in particular, the very fact that BT took action in 2008 as quickly as it could to adjust prices, clearly demonstrates that BT had met its cost orientation obligation HH3 in 2008 and 2009.

65. That BT had sought to comply with its cost orientation obligation is affirmed by Ofcom's own subsequent actions. As part of the process of the Business Connectivity Market Review, Ofcom decided to impose certain prices caps on various products (the Leased Lines Charge Control ("**LLCC**"). In July 2009, as a result of the LLCC Ofcom set start price adjustments for WES and BES services. The prices considered in Ofcom's charge control assessment had not been altered since the price changes notified in November 2008. As a result of this charge control, Ofcom only considered that BT's BES 1000 rental prices required alteration. The alteration was a reduction of 17% on the charge control starting charge.

66. The reported AISBO portfolio return declined from 37.3% in 2009 to 13.5% in 2010 on a like for like basis. The prices notified in November 2008 represented the great majority of revenue reductions due to price decreases. The price reductions notified in November 2008, on a full year basis for 2008/09, are estimated at £90.7m. BES1000 rentals revenue in 2009/10 was £17m; whereas Ofcom's start price adjustment in July 2009 is estimated to have reduced 2009/10 reported AISBO revenues by merely circa £2.9m. The first charge control year price reductions in January 2010 is estimated to have reduced 2009/10 AISBO revenue by a further £13.7m. Given that AISBO

services volumes grew in 2009/10, all other things equal, the price reductions notified in November 2008 had by far the biggest revenue impact on reducing margins in 2009/10.

3.8 An analysis of material in 2011

67. BT contends that the historical analysis given above is more than sufficient to demonstrate that BT plainly complied with the Condition, particularly given the latitude inherent within that obligation. BT contends that any attempt now to carry out a major retrospective investigation is unfair on BT and an inappropriate use of the dispute resolution powers. Judging BT in a context markedly different to the context in which BT was operating in 2004-2009 is unrealistic and wrong in law.

68. BT does not however shrink away from making it clear that, even if Ofcom conducts such a major retrospective investigation, BT can demonstrate it was still fully compliant with the Condition. However, the starting point must necessarily be that the investigation has to look at all the data now available. That not only includes using data, such as international material, which is now available, but also involves using the most up to date figures, including the most relevant ROCE and DSAC figures.

3.9 Relevant material Ofcom should consider

69. Ofcom should not focus exclusively, or even primarily, on the individual DSACs of each and every product.[30] It goes without saying that BT's charges can be cost orientated even though the charge for an individual product is above DSAC. BT cannot be expected mechanistically to demonstrate that individual charges for each and every single charge or product always fell below DSAC. That is all the more compelling in this specific market[31] for the reasons already expanded upon above.

70. In a developing market like AISBO, any analysis needs first to consider rates of return within the market and then DSACs for the market as a whole. A new product cannot be considered in isolation given that (a) the common costs are spread across the market and (b) the risk of whether a new product succeeds or fails is necessarily borne by that market. Ofcom itself implicitly acknowledged this in only requiring in the RFS a breakdown for the market as a whole in 2004/5 and for only two items in 2005/6.

[30] BT would add that DSAC (and DLRIC) are not "generally accepted" methodologies, for regulatory purposes, of measuring costs. DSAC and DLRIC have only ever been used (and their use remains contentious, in part for the reasons set out in Section 4 below) in telecommunications regulation. Whether BT's charges are cost orientated is a matter of assessment and weighing of all the available evidence; DSAC and DLRIC, being formulaic in nature, do not demonstrate compliance or non-compliance with a Basis of Charges condition and are merely, at best, indicators.

[31] i.e. the AISBO Market as defined in the 2004 LLMR. Whatever the position concerning PPCs, there a numerous points of distinction with the AISBO market.

71. Moreover, there are significant specific reasons why, in this market, individual elements cannot be looked at in isolation. Individual product elements are always sold together with others. Thus, the local end "rental" element is always sold with the "connection" element. This has been recognised by Ofcom in its LLCC process (see e.g. §5.8 of the 2 July 2009 LLCC) when considering start price adjustments.[32] Accordingly, in considering the issue of cost orientation it is impossible to ignore the link between these two elements.[33]

72. This is not an analogous situation to the PPC case where BT argued that trunk was always sold with TISBO. Whatever the rights and wrongs of that particular contention, it was clear that the disputing parties in that case had the opportunity to buy trunk in TISBO in different proportions according to their perception of the benefits of the buying trunk.[34]. However, specific local end rental and connection elements can never be bought in variable proportions: they are only ever purchased in fixed proportion to each other. In short, they are one purchase unit in a single defined market. As such, BT was and is entitled to have regard to this combination in demonstrating its cost orientation compliance.

3.10 BT's Rates of Return

73. If one starts with the issue of ROCE, it clearly demonstrates that BT, with the exception of one period, kept its prices for the AISBO market at or below 20%. That is properly consistent with BT's charges being cost orientated, which is not to say that a charge above this level would be abusive.[35]

74. As regards that one period, as already explained in section 3.7 above, once the problem was identified from the draft RFS for 2007/8, BT immediately tried to change its prices down to reduce the ROCE. In fact, this could not be done immediately as explained in that section above and that is the only reason why ROCE remained high in 2008/9. Had BT been able to introduce the price changes sooner in 2008/2009, the reported return for the AISBO market would have been 26% as opposed to 37%. The reported AISBO portfolio return declined from 37.3% in 2009 to 13.5% in 2010. The prices notified in November 2008 accounted for the great majority of the decrease. The price reductions notified in November 2008, on a full year basis for 2008/09, reduced revenues by about £90.7m. In contrast, the start price adjustment in July

[32] Ofcom has followed this approach, for example, when responding to BT's concerns around the operation of the Basis of Charges condition in both the WLA and WBA market reviews – See Ofcom's letter to BT of 6 December 2010

[33] This follows both from the flexibility in the parameters referred to in section 3.3 above; by way of example only the definition of Network Access (which is linked back to section 151(2) – (4) of the 2003 Act), that costs are to be reasonably derived and that BT is allowed an appropriate mark up and return on capital.

[34] See for example the PPC Final Determination at §§7.64-7.66 and §§ 33-35 of the Substantive PPC Judgment

[35] Ofcom itself appears to have accepted that 25% ROCE is not unreasonable: see in particular Ofcom's slide presentation of 15 October 2008 by its LLCC Project Team

2009 is estimated to have reduced 2009/10 reported AISBO revenues by £2.9m, whilst the first charge control year price reductions in January 2010 reduced 2009/10 revenue by a further £13.7m. Thus, the November reductions accounted for about 85% of the reductions leading to the fall in the ROCE to 13.5% in 2010.

75. BT sets out a table of the respective ROCE given the date when the RFS figures were actually published and various other dates that are highly relevant to any cost orientation analysis. To put these figures in context (and in particular that they are not all what one would expect from non-cost orientated charges), in the PPC case, for the years in which there was a breach of the cost orientation condition found, the ROCE for all Trunk varied between 57.6% and 93.3%: see PPC Final Determination Table 7.3.

Table 1: ROCE in the AISBO market measured against significant events.

Event:	04/05	05/06	06/07	07/08	08/09	09/10
RFS publication date	Sep 05	Sep 06	Aug 07	Sep 08	Aug 09	Jul 10
Reported ROCE AISBO CCA basis	8.80%	15.90%	20.0%	31.10%	37.30%	13.50%
Phase 1 WES/BES price changes notified			Dec 06			
S.135 Response re cost orientation				Jun 07		
EBD and EAD launch notification					May 08	
Draft 2008 RFS review					Jun 08	
Price reductions notification following RFS review					Nov 08	
LLCC BES 1000 start price adjustment						Jul 09
First year of control price reduction						Jan 10

3.11 The DSAC figures

76. Following a review of the calculation of DSAC in BT's LRIC model, BT discovered a number of errors that resulted in the calculated DSACs being less than FAC for a number of cost categories. These plainly showed errors in the underlying attribution process. The reason for these errors was that certain fixed and common costs were not appropriately attributed to BT's WES and BES services.

77. The errors mean that, not only have the published DSACs for 2006/2007 in respect of some BES rental services been below FAC but also, the DSACs calculated and published in the RFS for WES and BES services through the Relevant Period have been much less than they otherwise should have been. In other words, the DSAC ceiling was set too low.

78. An 'off-line' correction to the LRIC model has been completed, adjusting the DSAC values for the charges in dispute, to ensure consistency with the stated methodology for calculating DSACs. The result of these off-line corrections is to reduce the difference between the WES and BES revenues and the corrected DSACs, where the price is above DSAC, by approximately 40% during the relevant period. Ofcom has already been notified of these issues in BT's s 191 Response (Q.17) and raised additional questions to which BT has responded.

79. Even without any adjustments to DSAC, it is clear that BT's charges for the AISBO market did not consistently exceed the DSAC ceiling other than for intermittent odd years. This can be seen from the Disputing Parties own material. RGL's Figure 2[36] shows that DSAC was not exceeded for 2005/6 or 2007/8. In short, there was no period of two consecutive years in which DSAC is exceeded.

80. BT would add this. It is ironic that if BT had relied exclusively on the DSAC figures, BT would have been below the DSAC ceiling for the AISBO market in 2007/8. However, precisely because BT was considering the ROCE figures as well, BT realised it was in danger of becoming non-cost orientated and actually sought to adjust its prices: see section 3.7 above. This further demonstrates that a mechanistic reliance on DSAC is not the correct approach to cost orientation. However if one incorporates the adjustments, this shows that, for the AISBO market as a whole, BT's charges should be below DSAC in the years 2004 to 2010. Even concentrating on just WES and BES products it is clear that for these, as a whole, BT's charges were only above DSAC in one year (2006/07). The figures are shown in Table 2 below.

Table 2: BT charges above DSAC

	2005/06	2006/07	2007/08	2008/09	2009/10
Total for BES & WES	-	1,913,607	-	-	-

81. When coupled with the information above as to ROCE, this is an important piece of evidence in demonstrating that BT met its cost orientation obligation. If DSAC for the market as a whole has not been exceeded in any year (or even if exceeded only for random intermittent years as the RGL data supposed), it makes it highly unlikely that

[36] page 11

BT has not met its cost orientation obligation imposed in respect of that market. Plainly, BT is allowed a latitude in its prices between products in this nascent market, particularly given factors that have already been discussed in the various paragraphs above. How BT distributes costs between products within that market is a matter of judgment, not an exact science. If the market is compliant it makes it very unlikely that fluctuations the result of an overly granular investigation are caused by anything other than an attribution quirk rather than a more fundamental over recovery in that market. That is very different to PPCs where BT had sought to aggregate over two markets.[37]

82. Even if the DSACs are considered at a more granular level, they still do not suggest a wholly consistent pattern. Any finding of a breach of an SMP condition is a very serious matter for a party subject to such condition. In addition, the sums sought by the Disputing Parties are large. Ofcom should only countenance making any such finding if there is truly compelling evidence that, in the specific circumstances of the AISBO market, BT did indeed obviously breach the Condition.

83. In fact when rental and connection for the individual bandwidths are looked at together (for the reasons set out in section 3.9 above) and the adjustments to DSAC to which BT has referred above, there is not a clear and obvious pattern of overcharging. The figures are set out in Table 3 below.

Table 3: Adjusted WES and BES DSACs

Service		2006/07		2007/08		2008/09		2009/10	
		External average price (£)	Unit DSAC (£)	External average price (£)	Unit DSAC (£)	External average price (£)	Unit DSAC (£)	External average price (£)	Unit DSAC (£)
WES 10 Circuits	*Connections & Rental*	4,759	8,154	2,928	5,343	1,829	2,461	1,813	3,996
WES 100 Circuits	*Connections & Rental*	6,530	7,354	5,706	5,588	2,504	2,407	1,927	4,288
WES 1000 Circuits	*Connections & Rental*	24,952	15,585	14,599	15,167	6,455	4,764	4,442	8,286
WES Other Circuits	*Connections & Rental*	27,569	20,292	9,453	20,300	6,069	5,356	6,815	3,481

Service		2006/07		2007/08		2008/09		2009/10	
		External average price (£)	Unit DSAC (£)	External average price (£)	Unit DSAC (£)	External average price (£)	Unit DSAC (£)	External average price (£)	Unit DSAC (£)
BES 100 Circuits	*Connections & Rental*	6,943	6,872	4,814	2,931	2,657	2,138	1,583	2,328
BES 1000 Circuits	*Connections & Rental*	15,488	10,112	14,021	6,504	4,610	2,910	3,707	8,251
BES Other Circuits	*Connections & Rental*	13,026	10,324	1,990	3,117	689	2,258		

84. Only for BES 1000 circuits is DSAC exceeded substantially in three consecutive years. (Whilst BES 100 connection and rental prices exceed DSAC for 3 years, for two of those years the excess is very slight).

85. These "excess" figures must of course be put in the context of the market as a whole, in particular that these were relatively new products, the precise outcome of which was

[37] By way of contrast in the PPC case for the single trunk market as a whole BT had exceeded DSAC on three out of four years: see Table A12.2

unclear and the volumes for which were very difficult to estimate. An indication of the problems can be seen from the very high volatility of the individual DSAC figures from year to year. That again makes predictions as to charges going forward highly difficult.

86. The apparent "excess" of three years simply cannot be mechanistically taken as an indication of overcharging. It would be wholly wrong to divorce this from the reality of what BT was doing. In particular as set out in section 3.7 above, BT took steps to reduce its charging but was unable to do this immediately, at least in part, because one of the Disputing Parties was actually stopping BT from reducing the charges. At least one year of "excess" is directly attributable to this.

3.12 International benchmarking

87. BT commissioned OVUM to carry out benchmarking analysis of BT's WES and BES services against services offered by the incumbent operator in number of other European member States (France, Spain, Netherlands, and Italy).

88. This analysis is at Annex 2 of the Response. It should be noted that this is a much more substantive and robust analysis of the international market than that which was carried out in the PPC case. In particular, to avoid the suggestion that BT has failed to carry out a true like with like comparison, very clear parameters were laid down for the benchmarking exercise.

89. The result of this analysis is that, in respect of like for like circuits, BT's charges are either below average or amongst the cheapest. This is a clear indication that BT's charges are priced well within, and most likely at the low end, of pricing that would be expected in an effectively contestable market.

3.13 The absence of other evidence of breach

90. Moreover given that the purpose of cost orientation it to ensure pricing consistent with operation in a competitive market, market evidence is, on any view (and without prejudice to the points in section 4 below), relevant to an assessment of cost orientation. Charges that are not cost orientated are likely to cause some manifestation of economic harm and these are likely to be obvious and clear.

91. Thus, prices which are "too high" will suppress demand and, when the services are wholesale services (and thus inputting to other services), lead to a lower level of demand at the retail level. Suppliers who rely on the service will therefore not successfully grow their businesses, and end-user prices will be too high. Suppliers using the service as an input might also lose out at the retail level to an integrated supplier of the wholesale service if there is a "margin squeeze" in place. Therefore, non-cost orientation would be indicated by either (or indeed both):

    i. a slow growth in demand (both at the wholesale level and at the retail level); and/or

    ii. an increase in market share at the retail level for the integrated supplier.

92. BT contends that neither of these effects occurred over the relevant period. As explained above (see e.g. section 3.5), demand for WES and BES products consistently exceeded industry forecasts over the relevant period. Furthermore, the main external purchasers of the service all strongly grew their businesses over the time. Against the objective counter-factual of independent forecasts, BT's prices did not therefore have any significant constraining impact on demand.

93. Second, BT's share at the retail level fell significantly over the period, indicating that there was no margin squeeze.

94. It is also worth recognising that, although Ofcom had found barriers to entry in the market in 2004, competition in the provision of Ethernet services grew over the period as infrastructure competition took root. Indeed, as discussed above, Virgin Media actually objected to Openreach bringing forward the price reductions in late 2008, even though it was a purchaser of these services. Such action clearly demonstrates that it felt that its interests were best served by higher Ethernet charges (even though it now seeks to claim that it had been disadvantaged by charges being too high).

95. Finally, as already noted above, when Ofcom considered the matter in 2008 and 2009 in the LLCC it did not consider that BT's starting prices, with one exception, required any adjustment (see section 3.7above). This is provides clear evidence that BT had been seeking to secure its charges were cost orientated and demonstrated that fact to Ofcom.

3.14 Conclusion

96. An allegation (as made by the Disputing CPs) that a dominant provider breached its cost orientation obligation is a serious matter which should not be accepted without very clear evidence. The cost orientation obligation can only be considered in the context of the market in which it is imposed. Attempts mechanistically to "read over"

methodology and approaches in the PPC case would be a serious error. There are a significant number of factors in respect of AISBO market and Ofcom's approach to it that mean BT must be accorded a wide latitude in its compliance with its obligation.

97. Further BT did take proper steps to ensure compliance. Despite the inherent difficulties in a developing market (in particular the lack of historic data and significant increases over those forecast), BT was able to justify its charges to Ofcom in 2007. Moreover as soon as BT perceived that there might be a problem in 2008 it took steps to reduce prices but was actually prevented from doing this immediately precisely because of objections from the very parties who now complain of overcharging. Very significant price reductions were introduced in 2008/09.

98. Moreover the evidence BT has now adduced strongly indicates that it was compliant in the circumstances of this case. Even at the lowest level of aggregation that might be deemed appropriate (on the basis of combined rental and connection for each WES and BES bandwidth) it is relatively clear that there was a reasonable derivation of charges from costs even if charges have, on occasions, been above DSAC. Given the nascent nature of the services, the fact that growth consistently exceeded forecasts, and the very significant portfolio issues that needed to be recognised, BT should not be found to have breached its obligations regarding cost orientation.

99. Accordingly any finding of breach by BT of condition HH3 would be both unjust and entirely wrong in the circumstances.

4. Legal errors if Ofcom follow Substantive PPC Judgment

4.1 Legal Framework

100. In exercising its powers in any dispute referred under ss.185-191 (as the Disputing Parties request Ofcom so to do), Ofcom must have regard to its duties under s.3(3), which include an obligation to act in a manner that is transparent, accountable, proportionate and consistent. The principle of proportionality means that the measure: *"(1) must be effective to achieve the legitimate aim in question (appropriate), (2) must be no more onerous than is required to achieve that aim (necessary), (3) must be the least onerous, if there is a choice of equally effective measures, and (4) in any event must not produce adverse effects which are disproportionate to the aim pursued*", see *Tesco v Competition Commission* [2009] CAT 6 at paragraphs 135 *et seq*, especially at paragraph 137.

101. Moreover Ofcom's duties under ss.185-191 are expressly subject to the CRF, as provided for by s. 4(2). In particular Article 8 FD, which applies to all Ofcom's

regulatory tasks including Dispute Resolution (see e.g. §89 of the *TRD Core Issues Appeal*[38]), is expressly referred to in s. 4(2).

102. The CRF expressly places Ofcom under a duty, when carrying out its regulatory tasks (including dispute resolution) to "*promote competition*" by, *inter alia,* "*… ensuring that there is no distortion or restriction of competition in the electronic communications sector; [and] … encouraging efficient investment in infrastructure*" (Article 8(2) of the FD). The measures taken must be proportionate to those objectives (Article 8(1) of the FD) and Ofcom must exercise its powers transparently (Article 3(3) of the FD). Indeed in *Arcor*, the ECJ expressly held that a cost orientation provision must be interpreted in the light "*not only of the wording of that principle but also of its context and the objectives pursued by the legislation laying down that principle.*" (§ 57).

103. Accordingly BT contends that in any assessment of BT's cost orientation condition and in particular whether BT has breached its cost orientation Ofcom must:-

    a) carefully consider the actual effects on competition and investment;

    b) conduct a proper economic analysis;

    c) only intervene if it is proportionate; and

    d) act consistently with its (or its regulatory predecessor's) statements and approaches previously adopted. In particular BT contends that Ofcom cannot take an approach that is inconsistent with:

        i. the guidance that it has previously published as to how it would approach cost orientation (including both the Guidelines that it has published which are referred to below and the material set out in section 3 2);
        ii. the requirements it imposed upon BT in terms of both introducing new products (see section 3.2 and 3.4 above);
        iii. the methodology it required BT to adopt in its RFS (see section 3.4 above).

104. Oftel has previously published Guidelines on, inter alia, cost orientation in 1997 and 2001. In particular, the 1997 Guidelines ("*Guidelines on the Operation of Network Charge Controls*") provided for the limited assistance that DSAC ceilings can provide. Thus whether the charge falls between its incremental cost floor and stand-alone cost ceiling is "*a first-order test*", but the "*primary focus*" of investigation of a complaint (of non-cost orientation) will be "*... the effect or likely effect of the charge on competition and consumers.*" [emphasis added][39]. That,

[38] *T-Mobile v Ofcom* [2008] CAT 12.
[39] At § 3.5.

"*In general, Oftel would consider a good first order test of whether a charge is unreasonable or otherwise anti-competitive to be whether the charge falls within a floor of long run incremental cost and a ceiling of stand-alone cost ...*"[40]

"*In investigating complaints about charges, Oftel would not apply the floors and ceilings test mechanistically. Floors and ceilings are an effective first order test for the likelihood of anti-competitive or exploitative charging. However, there may be circumstances in which charges set outside the bands of floors and ceilings are not abusive, or charges set within the band are abusive. ... If asked to investigate charges, Oftel will seek to analyse the effect of the charge in the relevant market and will take a view on this based on the individual circumstances of each case.*"[41]

[Emphasis added]

105. The "*Network Charges from 1997, May 1997*" consultation document also provided at paragraph 6.28 that "*The key question is the effect of the charge ...*" [emphasis in original]. The 2001 Guidelines ("*Guidelines on the Operation of the Network Charge Control Issue 2*") provided similarly to the 1997 Guidelines.

4.2 The Substantive PPC Judgment

106. In the Substantive PPC Judgment, the CAT took the approach that the question of whether a charge was cost orientated was simply a matter of construction of the Condition, without regard to any wider legal principles discussed in section 3 above.

107. In particular:-

i. as regards s.3(3) CA 2003, the CAT concluded that "*section 3(3) does not of itself create any additional obligations on OFCOM beyond those ordinarily conferred by public law.*"[42] While the CAT accepted that the CRF was relevant to the "*factual matrix*"[43], it did not refer to the CRF in interpreting or applying the concept of cost orientation;

ii. nor did the CAT find the Guidelines of assistance; it considered that the Guidelines "*... are of mainly historical interest, and tend to be of marginal, if any, assistance* [to what is meant by cost orientation];"[44]

[40] Annex C at §C.1.
[41] Annex CAT §C.2.
[42] § 207(7) of the Substantive PPC Judgment.
[43] § 203 of the Substantive PPC Judgment.
[44] § 204 of the Substantive PPC Judgment

iii. the CAT also rejected the relevance of the economic harm analysis in relation to the interpretation and application of the Condition[45].

108. BT contends that the approach adopted by the CAT in reaching these conclusions was legally flawed and if Ofcom were to follow the approach of the CAT in deciding the present disputes, it would be committing fundamental errors of law. (This is without prejudice to BT's contentions set out in section 3 above that, even if the CAT were correct in its conclusions, there are substantive differences in the Dispute References and the PPC case and Ofcom should, for all the reasons set out in that section, still not find BT to have been in breach of the Condition.)

109. BT has already set out summary grounds of its challenge to the CAT's reasoning in its application to the CAT for permission to appeal the Preliminary and Substantive PPC Judgments, a copy of which Ofcom has already received and, despite the opportunity provided by the CAT, declined to comment upon. BT will not, therefore, rehearse all BT's arguments as to why the CAT's approach was wrong and why Ofcom should follow the legal framework set out in section 4.1 above. BT will simply make three brief points why the reasoning of the CAT is wrong.

4.3 Ofcom's duties under s. 3(3)

110. The CAT's dismissal of the s.3(3) duties as not adding anything to English law is, with respect, a clear error of law. To take the proportionality duty first, by way of example, there are two clear errors:-

i. contrary to the CAT's dictum, the current position is that proportionality is not recognised as a self-standing principle of English administrative law,[46] and

ii. further, the present case involves the application of the EU harmonised CRF regime which also contains an explicit proportionality requirement in Article 8(1) FD.

111. This error of law led the CAT to apply the cost orientation in the Condition incorrectly. A proportionality exercise requires more than simply determining whether the charges for Trunk were above the DSAC level. On the contrary, a proportionality exercise requires consideration of[47]:

[45] §§ 320-327 of the Substantive PPC Judgment

[46] See e.g. *R v Secretary of State for the Home Department, Ex p Brind* [1991] 1 AC 696, *Regina (Alconbury Developments Ltd and Others) v Secretary of State for the Environment, Transport and the Regions* [2003] 2 A.C. 295, §51, *Regina (Association of British Civilian Internees: Far East Region) v Secretary of State for Defence* [2003] QB 1397, §§ 34 to 37 and *Somerville v Scottish Ministers* [2007] 1 W.LR. 2734, §§ 53 to 56.

[47] See *Tesco v Competition Commission* *referred to in section 4.1 above.*

i. the aim of the cost orientation provision;

ii. whether using the DSAC test would be effective in achieving that aim;

iii. whether there is a choice of equally effective or additional tests that could be undertaken and, if so, which of those is the least onerous measure; and

iv. whether the DSAC test (or indeed any other test) would produce adverse effects which are disproportionate to the aim pursued.

112. In the Substantive PPC judgment, the CAT failed to consider the aim of the cost orientation provision. That provision is not an end in itself but a means of ensuring that there is no distortion or restriction of competition in the real world. The CAT further failed to consider whether the DSAC test, to the exclusion of any competition analysis, was appropriate or effective in ensuring that there is no distortion or restriction of competition. Finally, the CAT also failed to consider whether using a DSAC test, to the exclusion of (a) any competition analysis and (b) any analysis of the economic effect.

113. Secondly, the CAT's approach also ignored the requirement for Ofcom to conduct its regulatory activities in a transparent, accountable and consistent manner under s.3(3). By way of example, for the reasons set out in Section 4.5 below, the CAT's failure to place virtually no weight upon the 1997 and 2001 Guidelines was a serious error.

4.4 The CRF Duties

114. The 2004 LLMR cost orientation conditions were imposed by Ofcom pursuant to the SMP provisions in the AD. The Dispute Resolution procedure under ss.185-191 is derived from Article 5(4) of the AD and Article 20 of the FD and Ofcom is expressly required to apply the principles and objectives in Article 8 of the FD in resolving disputes. Accordingly Ofcom is obliged, under the duty of consistent interpretation in Article 4(3) of the Treaty on European Union, to construe and apply the cost orientation condition in the light of the scheme and objectives of the CRF[48].

115. The CRF requirements include the harmonised application of a regulatory framework throughout the EU, pursuant to which NRAs, like Ofcom, have a duty to promote competition (Articles 1(1) and 8(2) of the FD). On this basis, Ofcom cannot resolve a dispute without taking into account and assessing the effects on competition of any solution that may be imposed. Moreover, the result achieved must be proportionate to such considerations of promoting competition, as stated in Article 20(1) of the FD and ss. 3(1) and (3)[49].

[48] See Case C-106/89 *Marleasing* [1990] ECR I-4135, § 8 and *Arcor* Case C55/06, § 57.
[49] Reinforced by the judgment of the CAT in the *TRD Core Issues Appeal* cited in Section 4.1 above particularly at §101.

116. The CAT thus committed an error of law by construing the cost orientation solely by reference to its terms, without regard to the CRF. That error of law led the CAT to adopt the wrong approach to cost orientation in a number of respects. For example,

i. It did not take account of the policy objectives in Article 8 FD when construing the scope and meaning of the cost orientation condition. Its construction of the nature of the cost orientation obligation imposed by the terms "r*easonably derived from the costs of provision*", "*appropriate mark up for the recovery of common costs*" and "*appropriate return*" in that condition was flawed as the CAT omitted totally to consider Ofcom's duty, pursuant to Article 8(2) of the FD, to promote competition by ensuring that there is no distortion of competition and encouraging investment in infrastructure.

ii. The CAT's conclusion that DSAC was the only satisfactory cost orientation test (The Substantive PPC Judgment §§ 277 to 307, in particular at § 287) was wrong. Again, it erroneously excluded the legal relevance of any competition analysis. Such an analysis is an integral part of Ofcom's duty when acting in a Dispute Resolution procedure, as well as ensuring that any regulatory intervention is objectively justified and proportionate. Indeed, the CAT itself accepted (at § 285 of the Substantive PPC Judgment) that: "*No-one suggested that DSAC was a conclusive indicator that common costs have been appropriately allocated. It was common ground that a charge for a service could be cost orientated even though it was in excess of the DSAC ceiling, and equally a charge below DSAC might not be cost orientated …"*. In the light of that conclusion it is impossible to see how the CAT could have relied solely on the DSAC test.

iii. The CAT's focus upon the specific products to the exclusion of considering the totality of the products (in that PPC case) was wrong. The totality of the products is a critical factor in any competition analysis (which the CAT also erroneously considered was not legally relevant). The rejection of the legal relevance of looking at the totality of the products is also inconsistent with the ECJ's judgment in *Arcor*, in which the ECJ stated that, whilst the NRA has the discretion to decide on the accounting methods used to assess cost orientation, the incumbent's prices must take account of all the actual costs, including costs already paid by the facility-owning operator in providing the infrastructure and forward-looking estimated costs of developing, upgrading or replacing the network or parts of it, plus a reasonable rate of return. The ECJ was taking a holistic approach. The failure to consider the products in their totality was the antithesis of the holistic approach laid down by the CRF and *Arcor.*

4.5 The 1997 and 2001 Guidelines

117. The CAT erred in holding that the 1997 and 2001 Guidelines were irrelevant to the question of determining whether BT's prices were cost orientated. As already discussed in section 3.3 above there are clearly a number of variable parameters in the cost orientation conditions imposed by the 2004 LLMR. These conditions lay down no methodology for determining those variables. However, the 1997 and 2001 Guidelines emphasise that the primary focus is the effect or likely effect of the charge on competition and on consumers.

118. Contrary to what the CAT said at § 205 of the Substantive PPC Judgment, this was not a case of BT seeking to construe the cost orientation condition in a manner inconsistent with its express terms. Rather, BT was seeking to rely on what Ofcom itself had said, namely that it was applying the Guidelines to the cost orientation condition.

119. Any consideration of a cost orientation condition must, in order to be consistent with Ofcom's previously stated guideline, have as its primary focus the effect of the charge on the competitive process, rather than focussing either exclusively or primarily on the DSAC test.

120. Indeed unless a proper economic harm analysis is conducted, no proper conclusions can be reached as to whether the condition has been breached. An approach, which proceeds on the assumption that there was an overcharge (using the DSAC test) and then considers the effects on consumers and competition of such an overcharge, is flawed. It is an entirely circular exercise whose outcome is entirely predictable. It begs the very question of whether there was an overcharge. So, far from the economic harm analysis being a primary and independent focus of whether the charge for trunk is cost orientated, it instead is entirely parasitic on any overcharge found under the DSAC analysis.

121. The effect of the CAT's reasoning is that the DSAC approach ceases to a "first-order test" to, for all practical purposes, the one and only test to determine whether BT's prices are cost orientated. This was manifestly contrary to the Guidelines.

5. Remedy

5.1 The Disputing CPs' Claims

122. The way that the Disputing CPs have put their claims for a remedy under section 190(2)(d) is misconceived in that it confuses different remedies and moreover seeks remedies that Ofcom cannot grant. In addressing these points, BT makes clear that

this is entirely without prejudice to section 2 above, namely that ss.185-191 were never intended to apply to such historic issues.

123. Sky / TTG state at paragraph 6 of their Dispute Reference that,

> "*... the Purchaser Parties have been overcharged for BES. The Purchaser Parties are thereby each entitled to receive a refund for the amount of the overcharge, together with interest (which the Purchaser Parties contend should be compound interest at an appropriate commercial rate). Only in this way can the Purchaser Parties be properly compensated for the overcharges they have suffered in consequence of BT's breach of its regulatory obligations; and only in this way can BT be properly deprived of the benefit it has obtained by its breach.*"
>
> [emphasis added]

124. BT would also refer to paragraphs 15, 16, 17, 53, and 62 to 72 of the Sky/TTG Dispute Reference. It is important to note that paragraph 62, of that Reference, provides (in relevant part) that:

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

125. Paragraph 68 of the Sky/TTG's Dispute Reference states (in relevant part) as follows:

> "*...Ofcom's powers to resolve a dispute are set out in primary legislation: section 190 of the Communications Act 2003. These powers include a power to give a direction requiring a communications provider to pay a sum of money to another communications provider. It is implicit in the scheme of the legislation and the regulatory regime that Ofcom is both entitled and required to make a judgment in each case as to what (if any) sum should be paid by one communications provider to another in circumstances where the first provider has breached the regulatory obligations applicable to it, and as a consequence has overcharged the other*

provider. Ofcom can and should make a judgment as to what sum is appropriate in order properly to remedy the breach."

[emphasis added]

126. The Virgin dispute submission provides (at paragraphs 46 and 50) as follows:

"*46. In the present case, there are no alternative means for resolving the dispute. There is no cause of action before the civil courts and there is no prospect of ADR.*

...

50. Virgin believes that a direction for an overpayment is appropriate given the fact that BT is subject to an SMP obligation which requires it to charge cost oriented prices. The SMP obligation was imposed in order to resolve competition problems in the relevant market. Resolving the dispute in this way would therefore be fair as between BT and Virgin and would also be reasonable from the point of view of Ofcom's regulatory objectives and consistent with Ofcom's community requirements as set out in the Communications Act 2003."

[emphasis added]

127. The section 190 (2)(d) regime cannot be both compensatory and restitutionary at the same time. These are very different and separate concepts. Compensation means providing the claiming party with a monetary award for the loss and damage it has actually suffered as a result of the breach. In contrast restitution broadly means reimbursing the claiming party for the enrichment that the defendant has received at the expense of the claiming party in circumstances where it is unjust for the defendant to retain that enrichment. Accordingly the section 190 (2) (d) regime can only possibly involve one of these concepts. BT addresses this more fully below.

128. However, the Disputing CPs' error goes even further.. The Disputing CPs seek remedies under section 190(2)(d) that Ofcom simply does not have the power to award. Ofcom's powers under section 190(2)(d) are limited to giving a direction (for the purpose of giving effect to a determination by Ofcom of the proper amount of a charge in respect of which amounts have been paid by one of the parties of the dispute to the other), enforceable by the party to whom the sums are to be paid, requiring the payment of sums by way of adjustment of an underpayment or overpayment. That is all that Ofcom is empowered to do under section190(2)(d) and any determination / direction that goes beyond this limited power will be an error of law. The use of the word "repay" by the Disputing CPs is also incorrect and indicative of their misconception about the nature of section190(2)(d).

129. Ofcom is under European and English public law duties in relation to how it exercises its power under section 190(2)(d), which BT addresses more fully below. A proper analysis of these legal principles demonstrates that the nature of s.190(2)(d) is either compensatory or restitutionary, not penal. If it is compensatory, then actual loss must be demonstrated by the CPs before any payment should be ordered against by Ofcom

against BT and in favour of the CPs. Account must be taken of mitigation of loss and passing-on. If the nature of s.190(2)(d) is restitutionary, account must be taken of proper restitutionary principles, including counter-restitution. The issue of alleged overcharging must be looked at in the round. In any event, any payment ordered must not have penal effects.

130. BT notes here that Virgin asserts at paragraph 46 of its dispute submission that there is no cause of action before the civil courts. It is plain that Virgin does most definitely have a remedy in the civil courts, where it can prove that the breach has caused loss or damage. This is absolutely clear from section 104. Virgin, thus, is implicitly admitting that it cannot demonstrate that it has actually suffered any loss or damage as result of the alleged breach by BT of Condition HH3. BT asserts that, given that admission, Ofcom simply cannot and should not order any payment under s.190(2)(d).

131. After briefly considering the PPC judgment, BT will address the issues raised in the following order:-

i. The limitations that are in any event imposed upon s.190 (2) by EU Law;
ii. That under English Law an award under s.190 (2) must be compensatory and cannot be punitive;
iii. Even if an award under s.190 (2) were to be restitutionary, Ofcom has to take into account the overall picture and all "counter restitutionary factors.

5.2 The PPC Judgment

132. In the Substantive PPC Judgment, the CAT asserted (in BT's submission, in error) that Ofcom has a "hard" discretion under s.190(2)(d) which requires it to follow through on the conclusions it has drawn pursuant to the DR process[50] and that this entails a "restitutionary approach", whereby BT has to pay the full amount of the difference between its actual charges and DSAC. In so doing, the CAT failed totally to consider whether the payment ordered by Ofcom in respect of a cost orientation condition satisfied both the proportionality requirements and the specific duties in Article 8 FD[51].

[50] Substantive PPC Judgment, §§ 182 and 338.

[51] As already discussed in section 4 above, the CAT erred in law in holding at § 207(7) of the Substantive PPC Judgment that s.3(3) CA 2003 did not confer any additional obligations on Ofcom beyond those ordinarily conferred by (English) public law. Proportionality is not recognised as a free-standing ground of review in English administrative law but that does not apply in a case involving EU/ECHR law. The present case involves the application of the harmonised EU CRF and, more particularly, the explicit proportionality requirement in A8(1) FD.

5.3 EU Law

133. The CRF empowers NRAs to resolve disputes and to "*impose a solution on the parties*" (Recital 32 FD) but is silent as to the precise means of enforcement. As a matter of EU law, Member States are required to choose the most appropriate form and methods to ensure the effectiveness of directives, in the light of their objectives[52]. In the absence of specific EU provisions, the cause of action and the substantive and procedural conditions for relief are left to domestic law subject to the limits imposed by EU law[53].

134. As a matter of public law, as the designated NRA under the CRF, Ofcom is obliged under the duty of sincere cooperation in Article 4(3) TEU (formerly Article 10 EC) to ensure the achievement of the CRF objectives and to abstain from any measure that might jeopardise its uniform application and effectiveness. Disregarding the limits imposed by the CRF would undermine the harmonised application and primacy of EU law.

135. In addition to the fundamental principles of EU law, as discussed on section 4 above, Ofcom's DR powers have to be construed in the light of the objectives of the CRF. Ofcom's remedial powers in s.190(2) are explicitly subject to the duty of proportionality in Article 8(1) FD and the specific policy objectives of promoting competition and encouraging investment in Article 8(2) FD. The same duties are transposed by s.3(3) and s.4.

136. The requirements of proportionality require Ofcom, before deciding whether to order payment of a sum, to:

    (1) Identify the legitimate aim in question in ordering payment of that sum;
    (2) Explain why such payment would be effective to achieve that aim;
    (3) Identify the relevant considerations which ensure that the level of payment is targeted, necessary and proportionate and explain why the amount of payment is no more onerous than necessary and is the least onerous form of regulatory intervention if there is a choice of equally effective measures;
    (4) Ensure that such payment does not produce adverse effects which are disproportionate to the aim pursued; and
    (5) Ensure that such payment strikes the right balance in promoting efficiency, encouraging investment and ensuring that there is no distortion of competition.

[52] Article 288 TFEU (ex A249 EC); Case 48/75 *Royer* [1976] ECR 497, paragraph 75.
[53] See, for example, Case 33/76 *Rewe v Landwirtschaftskammer fuer das Saarland* [1976] ECR 1989, paragraph 5 and Case 68/79 *Hans Just v Danish Ministry for Fiscal Affairs* [1980] ECR 501, paragraph 25.

137. Ofcom is obliged to take account of the fact that the dispute before it concerned an alleged breach of a cost orientation[54] obligation rather than a price control cap. As touched on in section 3 above, the CRF provides for a scale of regulatory intervention, graduating from relatively light measures to "heavier" cost orientation obligations and ultimately the imposition of price control caps, as appropriate, depending on the degree of competition in the particular market and the nature of the problem identified (see ss.87(9) and 88, read in the light of Recital 20 AD and A8(4) and 13(1)AD).

138. When determining whether or not to order a payment under s.190(2)(d) CA 2003, Ofcom must consider whether a full payment would go beyond what is necessary to resolve the dispute and produces disproportionate adverse effects:

    (1) The payment sum ordered may constitute a windfall which affects the competitive relationship between BT Retail and its competitors[55]. Far from *promoting* competition, full repayment may *distort* the competitive dynamic between BT and its competitors in a way that fails to secure sustainable competition, efficiency or investment in the long term.

    (2) The payment may unfairly discriminate against BT Retail and therefore compromises BT's ability to compete downstream. BT is under various legal obligations to treat its own retail arm in the same way as CPs.

    (3) Account must be taken of the countervailing benefits which the disputing CPs enjoy as a result of purchasing WES and BES products from BT. Whether or not there has been overcharging must be looked at in the round.

    (4) The amount of any payment ordered should not be higher than the amount of any sanction that could be imposed on BT for contravention of a SMP condition. The maximum "fine" that can been imposed under s.97 is 10% of the turnover of the relevant business.

139. Ofcom must not impose an unjustified quasi-penalty on BT by requiring full payment of the difference between its charges and DSAC without any regard to its Community obligations of proportionality and competition. If Ofcom fails to have regard to its public law duties, the payment direction will be unlawful as being inconsistent with the applicable public law duties imposed on Ofcom by EU and English law.

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[54] A cost orientation condition, unlike a price cap condition, implies that there can be a range of prices that can be cost orientated rather than a precise price limit. Even then there can still be uncertainty: see the Substantive PPC Judgment, § 285, where the CAT held: "*No-one suggested that DSAC was a conclusive indicator that common costs have been appropriately allocated. It was common ground that a charge for a service could be cost orientated even though it was in excess of the DSAC ceiling, and equally a charge below DSAC might not be cost orientated …"*. There is therefore an internal inconsistency between the CAT's findings in § 285 and the "hard" discretion referred to in § 338.

[55] Ofcom should make enquiries about the extent to which the disputing CPs have passed on the higher charges to their customers.

5.4 English Law

140. Even if s. 190 (2) applied to historic issues, under English Law it plainly was intended to be compensatory. In any event, the basis of the payment regime in s.190(2)(d) can only possibly be either compensatory or restitutionary. It cannot be both and it certainly is not punitive. Moreover this in any event is clearly subject to the EU principles set out above.

141. To determine the basis of any payment regime under the s.190(2)(d) as a matter of English law, it is necessary to look at it in the context of the Communications Act? 2003 as a whole[56]. As set out above, Condition HH3.1 is an SMP condition. It can, therefore, be potentially enforced in three ways under the CA 2003:

    (1) First, an SMP condition can be enforced by Ofcom under its enforcement powers (ss. 94-103). Under s.96, Ofcom can impose a penalty for breach. However, pursuant to s.97, the amount of the penalty cannot exceed 10% of the provider's turnover in the relevant business. The term "relevant business" is defined at s.97(5). Those penalties are, in ECHR terms, criminal.[57]

    (2) Second, an SMP condition can be enforced (with the consent of Ofcom) by a CP under s.104 as breach of statutory duty owed to it, where the CP suffers loss or damage (s.104(2)(a)). However, it is a defence that the dominant undertaking took all reasonable steps and exercised all due diligence to avoid a contravention (s.104(3)).

    (3) Third, (and entirely without prejudice to BT's contentions in section 2 above) it can possibly be enforced via a DR Procedure under ss. 185-191, as Ofcom sought to do in the PPC case.

142. As a matter of English law, the s.190 regime must necessarily be civil and not criminal in nature. There is nothing to suggest it is criminal and, were it to be criminal, clear words would be needed[58]. Punitive regimes are unusual in civil law and require clear

[56] See, for example, Bennion on Statutory Interpretation (5th Ed., pp. 1155-1156): "***Section 355. Construction of Act or other instrument as a whole.*** *An act or other legislative instrument is to be read as a whole, so that an enactment within it is not treated as standing alone but is interpreted in its context as part of the instrument. Comment on Code S 355 ... It is firmly established that an Act or other instrument must be read as a whole.*" In *Customs and Excise Commissioners v Zielinski Baker & Partners Ltd* [2004] 1 W.L.R. 707 at [38], Lord Walker said "*... a holistic approach would seem to accord with the universally acknowledged need to construe a statute as a whole.*"

[57] See e.g. *Napp Pharmaceuticals v DGFT [2002] CAT 1 at §93*

[58] For example, Staughton LJ stated in *Secretary of State for Social Security v Tunnicliffe* [1991] 2 All ER 712 at 724, in relation to penalisation through retrospectivity, it is "*... a matter of degree – the greater the unfairness, the more it is to be expected that Parliament will make it clear if that is intended.*" And see, for example,

language, particularly where the burden of proof is on BT to show that its charges were cost orientated (see the burden of proof set out in Condition HH3 above). However, there is no such clear language in s.190(2)(d), or elsewhere in the CA 2003. Indeed, the opposite is true – other provisions of the CA 2003 specifically deal with enforcement and penalties (see ss.94-103). Accordingly, there is no question of s.190 allowing Ofcom to impose any punitive sanctions against BT for any alleged breaches.

143. To determine the basis of the regime as a matter of civil law, one should adopt a principled approach which reflects general principles inherent in other areas of the law, see, for Sales J in *4Eng Ltd v Harper* [2009] EWHC 2633 (Ch) who stated as follows at [13] and [16]:

> "*The principles in the application of the statutory regime should reflect…general principles inherent in other areas of the law, which treat the mental state and degree of involvement of a defendant in wrongdoing as relevant to the extent of the recovery against him…Helpful analogies may be drawn with other areas of the law to guide the court in reaching its conclusion, but given the wide range of situations which the statutory regime is intended to deal with it would be wrong to be unduly prescriptive in trying to lay down hard and fast rules for the application of these provisions.*"[59]

144. If, contrary to the arguments in section 2 above, it is right to conduct a historic investigation into alleged breaches of SMP conditions, then any payment regime under s.190(2)(d) is compensatory. This follows from the parallel enforcement regime for breach of statutory duty under s. 104(2)(a), which (as set out above) is compensatory in nature.

145. Section 190 would necessarily be part of an alternative civil enforcement regime to that of enforcement through the ordinary courts. A CP provider has a choice whether to seek enforcement of an SMP obligation in the ordinary courts or in front of Ofcom by way of a statutory form of conflict resolution. There is absolutely nothing to suggest that the powers available to Ofcom to award monetary remedies should be different from those of the ordinary courts. Ofcom's remedial powers are expressly limited to those conferred by s.190:

> "*... their only powers are those conferred by this section*".

Bennion at p.827 "*... the principle requires that persons should not be subjected by law to any sort of detriment unless this is imposed by clear words.*"

[59] This was a case about the interpretation of s. 423 Insolvency Act 1986 (setting aside transactions defrauding creditors) and how to balance the interests of the creditors and of third parties where Sales J considered that it was useful to refer to equitable and restitutionary principles in related case law, in particular liability for knowing receipt and the defences of change of position and bona fide purchase.

146. There, thus, is nothing in s.190 which explicitly gives Ofcom the power to make awards without any enquiry into the extent of the original payee's loss[60]. There is no logic or legal basis in Ofcom being able to award a CP greater sums in a DR regime than a CP would be able to obtain pursuant to an action for breach of statutory duty under s.104. In such a claim, the claimant would seek compensation for their loss (see s.104(2))[61]. Accordingly any payment direction made by Ofcom will be unlawful unless there is a finding of actual loss suffered by the CPs.[62] There is simply no evidence to support any such finding.

5.5 A Restitutionary Regime

147. If, contrary to what BT has indicated above, the s.190(2)(d) payment regime is not compensatory, then the only possible alternative is that it is restitutionary. However applying restitutionary principles, then it is clear that Ofcom should not make any order for any payment in this case. Whether s.190(2)(d) is compensatory or restitutionary, the result is the same – i.e. that Ofcom would be wrong to order BT to pay any sums to the CPs.

148. If a restitutionary approach to s.190(2)(d) is appropriate, it is necessary to take into account the benefits that the CPs have received from BT: in other words, "*counter-restitution*" must be taken into account so that restitution for the CPs does not result in their unjust enrichment at the expense of It is clear that in normal circumstances a plaintiff cannot expect both to get back something given to the defendant and at the

[60] S.190(2)(d) CA 2003 gives Ofcom the power "*to give a direction… requiring the payment of sums by way of adjustment of an underpayment or overpayment".* However, that does not mean that the sum required to be paid must be commensurate to the excess charged. Ofcom does not have to specify the exact sum to be paid in the direction but can direct the parties to agree the amount between themselves and provide the parties with the mechanism and indicia for so doing. By way of example, see the recent determination by Ofcom of 2 June 2010 of the NCCN 500 dispute. Accordingly, there is an opportunity for Ofcom to ensure that considerations of loss, mitigation and pass-on are taken into account in the final payment.

[61] Some of the CAT's own comments in § 338 of the Substantive PPC Judgment are more consistent with a compensatory analysis (than the restitutionary analysis that it says it adopted). For example, at sub-paragraph 338(3), the CAT held that, "*Ofcom's direction … sought to rectify some (but probably not all) of the adverse effects of BT's failure to comply with Condition H3.1.*"

[62] The CAT's reasoning in the Substantive PPC Judgment was internally inconsistent and wrong in law. If it is correct that the discretion under s.190(2)(d) CA 2003 is a "hard" discretion, in the sense described by the CAT, then it is not appropriate to describe this as a "restitutionary approach". If s.190(2)(d) CA 2003 simply requires Ofcom mechanistically to put into effect its determination of the proper amount of a charge, then it is not correct to describe this as being a restitutionary approach because a restitutionary approach is based on principles designed to ensure that neither claimant nor defendant is unjustly enriched at the expense of the other. Indeed, the CAT itself (in the Substantive PPC Judgment) alluded to there being non-mechanistic equitable considerations at § 338(2), stating "*Had BT carefully sought to apply Condition H3.1, but failed, then we consider that that should have been taken into account, and the amount BT would have to pay reduced*".

same time to retain something received from him: if there is to be a taking back there must be a giving back too.[63]

149. In the present case, the benefits conferred on the CPs by BT have to be taken into account: the matter must be looked at "*in the round*" and the court should do what is "*practically just*". It is blindingly clear that overall the CPs have not been disadvantaged. It is obvious (see the figures in Section 3 above) that looking at the AISBO market as a whole both BT's ROCE figures and its DSAC figures are well within the degree of tolerance that is expressly permitted by any cost orientation condition. Indeed that is all the more pertinent with a cost orientation condition applied to a developing market such as AISBO.

150. It is clear, therefore, that BT could recover its charges within the market in a fashion that is cost orientated. Even if the Disputing CPs were to be correct and BT has over-recovered on some products (which BT firmly denies), then account must be taken of the fact that BT has then not recovered what it was fully entitled to recover on other products on others. It could have, by resetting it charges, within the market have recovered the same amount. The CPs have therefore plainly had a very clear benefit. This counter restitution has to be taken into account in any restitutionary remedy and it plainly follows that, even if s190 were to be a restitutionary remedy, no award can or should be made. If Ofcom ordered any payment to be made by BT to the Disputing CPs in this case, which does not take into account the benefits received by the Disputing CPs from BT, this would be an unjust, unmerited and inappropriate windfall/enrichment.

6. Conclusion

151. The basis for the Dispute References is misconceived, there is no dispute over the amount of any payment from BT to the Disputing CPs due to BT's charges not being cost orientated, because, simply there has not been a finding that BT's charges were non-compliant.

152. The dispute should be determined on this basis and closed.

153. If, notwithstanding the misconception for the basis of the Dispute References, Ofcom none the less wishes (wrongly) to determine the compliance issue[64] in order to resolve the dispute, it is clear, that throughout the Relevant Period BT's charges for its

[63] The CAT in the Substantive PPC completely failed to consider this point and as such, BT firmly contends, its judgment is flawed.

[64] i.e. decide whether BT has demonstrated that its charges are cost orientated,

disputed BES and WES products, have been reasonably derived in accordance with the Condition.

154. Alternatively, Ofcom should determine that the appropriate charges for BT's WES and BES products, for the Relevant Periods, are the charges notified and charged by BT to the Disputing CPs.

155. Should Ofcom decide that BT has not demonstrated that its charges are cost orientated, Ofcom must, following as assessment of what would be an appropriate alternative charge, also assess whether a payment is required and the level of that payment. This latter assessment is not the difference between the actual charges and any charge that Ofcom may determine as appropriate and Ofcom must avoid such a simplistic and unlawful conclusion.

BT
20 May 2011

Annex 1 – The Ovum "Openreach – Ethernet Leased Lines Benchmark"