BCMR CALL FOR INPUTS: COMMON COST RECOVERY

PREPARED FOR TALKTALK

FINAL REPORT

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CONTENTS

1 EXECUTIVE SUMMARY

1.1 This report has been prepared in response to Ofcom's initial call for inputs ("CFI") for the next Business Connectivity Market review ("BCMR").[1] It addresses the specific question of whether costs that are fixed and common between regulated and non-regulated products (which we refer to as inter-group common costs ("IGCCs")),[2] should be recovered from the charges for regulated products.

1.2 Ofcom's current approach to setting most regulated charges implicitly includes an allocation of fixed and common costs (which would include IGCCs),[3] which "*allow for full cost recovery*".[4] This means that alternative Communication Providers ("CPs"), who purchase BT's regulated wholesale products, contribute to these common costs.

1.3 This report considers the case for including IGCCs in charges for regulated products (i.e. allowing a common cost mark-up) from first principles, and compares this to an alternative in which IGCCs would be excluded from the cost base of BT's regulated products. BT would then have to recover its IGCCs from its non-regulated products.

1.4 These approaches are considered in relation to their effects on potential competitive distortions (including those resulting from allocative inefficiencies), and productive and dynamic inefficiencies. Such an assessment finds that **allowing any mark-up on regulated products for IGCCs** could result in a number of distortions and inefficiencies, as follows.

1.5 **Competitive distortions in the retail market** – Ofcom has often referred to allocative efficiency as being maximised if prices are set at marginal/incremental costs, and where there are fixed and common costs these are allocated across products in inverse proportion to the price elasticity of that product/service.[5] However, this theory does not apply in this instance where the vertically integrated BT Group competes with non-vertically integrated CPs.[6] In the case where the regulated company is vertically integrated, IGCC mark-ups on regulated products can lead to a considerable risk of distortions to retail competition:

(a) Firstly, as a vertically integrated entity, BT Group perceives any mark-ups on regulated products as an internal transfer price with nil net cash impact, whereas for rivals the mark-up represents a real cash cost. This drives a "wedge" between the incremental costs which BT faces and that faced by rival CPs. As a result, rival

[1] Ofcom, "Business Connectivity Market Review: Timetable and initial call for inputs" ("Initial CFI") (1 April 2014) http://stakeholders.ofcom.org.uk/binaries/consultations/business-connectivity-market-review/summary/Business-Connectivity-Market-Review.pdf

[2] IGCCs will include, for example, a portion of group overhead costs such as CEO salary, human resources and investor relations costs.

[3] "Fixed" refers to whether the cost varies with output; common costs are typically fixed costs, but some incremental costs may also be fixed costs.

[4] See Ofcom, "Business Connectivity Market Review: Review of retail leased lines, wholesale symmetric broadband origination and wholesale trunk segments", 28 March 2013, §18.32-§18.35.

[5] See, e.g., Ofcom, "Wholesale mobile voice call termination" consultation, 1 April 2010, §A12.40. This suggests that unless one particular product is perfectly price elastic, common costs should be recovered from all products/services to some extent.

[6] This theory was originally intended to be applied to the optimal pricing policies of monopolists, and therefore would only have been applicable if BT were a monopoly in each of the markets considered.

CPs have dampened incentives to expand, whereas BT Group has relatively greater incentives to do so.[7]

(b) Secondly, because BT can enjoy unique economies of scope from vertical integration, the "wedge" may be aggravated by giving BT a per unit cost advantage which rival CPs cannot replicate.[8] There is therefore a risk that BT Retail could win volumes through such advantages even if its long run incremental cost ("LRIC")[9] for its retail division were higher than other CPs. These potential distortions would be avoided if any such economies of scope benefits were allocated to Openreach and not BT Retail. Reductions in Openreach charges are also likely to be passed on to end consumers in the retail market through competition between BT Retail and the CPs.

1.6 **Greater productive inefficiency** – the greater the proportion of IGCCs which are allocated to regulated products, the weaker will be BT's incentives to take actions to reduce IGCCs. Further, allocating no IGCCs to regulated products would mean that BT's IGCCs would be exposed in full to competitive pressures, further increasing cost minimisation incentives.

1.7 **Greater dynamic inefficiency for rivals** – "build or buy" signals may be distorted if mark-ups to charges for regulated products for recovering IGCCs were proportional to the amount of incremental cost incurred by each regulated product. If this were the case, the choice between two regulated products that have different incremental costs would be distorted, where the costlier product would become even more expensive by incurring a higher mark-up. This could disincentivise rivals from using such products in favour of investing in their own access or network infrastructure, potentially resulting in inefficient investment. Moreover, BT should be able to recover its efficiently-incurred IGCCs solely from non-regulated products, particularly given BT is likely to have unique economies of scope from vertical integration.[10]

1.8 **These distortions to competition and economic inefficiencies could be reduced if IGCCs were not recovered from regulated products**.

[7] This is particularly the case given that competition is differentiated in many retail markets relevant to the current BCMR, so that it is likely firms will still earn a positive margin. This may offer BT Retail sufficient "headroom" to lower prices to expand its volumes without triggering a margin squeeze test, earning greater revenues and profit by doing so.

[8] This includes the ability to "spread" IGCCs over both retail and wholesale operations (unlike its rivals, who can only recover corporate costs from retail activities), as well as unique economies of scope from vertical integration.

[9] These are the additional cost of providing retail services (the "incremental" cost), taking a long run perspective over which all costs are variable.

[10] In more detail, BT should be able to recover at most the amount of corporate overheads recovered by its competitors under this alternative approach. Any "stranded" IGCCs above this amount should be reassessed to ensure it is not in fact incremental to a particular BT division, or an inefficient BT expense resulting from diseconomies of scope or general productive inefficiency.

2 INTRODUCTION

Context

2.1 This report is prepared in relation to Ofcom's initial call for inputs ("CFI") for the upcoming Business Connectivity Market review ("BCMR").[11] In line with the previous BCMR, Ofcom will carry out the following stages of analysis:

(a) Define retail markets for leased lines and wholesale markets for terminating and trunk segments (which are key inputs for competitive leased lines services as well as for broadband and mobile services);

(b) Identify whether any firms have significant market power ("SMP") in any of the identified retail or wholesale markets; and

(c) Apply remedies to address SMP where it is found to be present.

2.2 The CFI seeks stakeholder views on a range of topics including (but not limited to) Ofcom's proposed approach to the BCMR, BT's quality of service in wholesale leased lines, and the approach to any potential charge control remedy that may be applied to BT's regulated wholesale products.[12]

2.3 AlixPartners LLP has been commissioned by TalkTalk Telecom Group PLC to review the basis of the underlying argument for whether inter-group common costs ("IGCCs"), i.e. costs that are common between regulated and non-regulated products (e.g. the common portion of Group overhead costs such as CEO salary, human resources, investor relations) should be recovered from any charge controls imposed on wholesale products. "Regulated wholesale products" relate to products that alternative CPs use to compete with BT in downstream/retail markets.

2.4 Under Ofcom's current policy, BT is currently allowed to recover a share of common costs (including IGCCs) from its regulated products. The share is determined by BT's cost attribution approach which is a fully-allocated cost (FAC) approach – Ofcom notes that both this FAC approach and LRIC+EPMU approach include "*an allocation of fixed common costs to allow for full cost recovery*".[13] This means that rivals who purchase BT's regulated products contribute to recovery of costs that are common. One of the implications of this approach is that CPs, which purchase regulated products from BT, contribute to the common costs across the BT Group (including costs common between Openreach regulated products and BT's non-regulated retail services). Under certain conditions (described further in this report), such an approach could lead to distortions in the retail market.

[11] Ofcom, "Business Connectivity Market Review: Timetable and initial call for inputs" ("Initial CFI") (1 April 2014) http://stakeholders.ofcom.org.uk/binaries/consultations/business-connectivity-market-review/summary/Business-Connectivity-Market-Review.pdf

[12] This would occur in the event that BT is found to have SMP in the relevant markets and charge controls are deemed to be an appropriate remedy.

[13] See Ofcom, "Business Connectivity Market Review: Review of retail leased lines, wholesale symmetric broadband origination and wholesale trunk segments", 28 March 2013, §18.32-§18.35.

2.5 This report considers the economic rationale for the current approach compared to an alternative approach in which IGCCs would be excluded from Openreach's regulated wholesale cost base. Under this alternative, BT would recover its IGCCs solely from non-regulated products (mostly provided by BT's Retail and Global Services operations). The objective of such a policy approach would be to minimise downstream competitive distortions while still ensuring that BT is able to recover efficient common costs incurred in providing its services. In this regard, regulated products would need to recover their own long-run incremental cost ("LRIC")[14] plus the costs that are common across regulated products (discussed in more detail below).

2.6 Accordingly, this report is written on the assumption that the IGCCs discussed are by definition fixed and common across regulated and non-regulated products, and identifies some of the issues that Ofcom should take into consideration when setting charge controls for regulated products provided by a vertically integrated operator.

2.7 For ease of illustration this report refers in places to Openreach as the (only) division within BT Group that provides regulated products, and BT Retail is the (only) division that provides non-regulated products. Ultimately, the divisional structure of BT does not matter to the question of how IGCCs should be recovered.

Definition of IGCCs

2.8 It is useful to define the IGCCs discussed in this report before proceeding.

2.9 IGCCs are the fixed and common costs between regulated and non-regulated products (including, for example, a portion of Group overhead costs such as CEO salary, human resources and investor relations). For the avoidance of doubt, the portion of such Group overheads that are *incremental* (or variable) to the provision of products is not included in IGCCs. For example some of the BT Group HR cost will be incremental to the number of staff, and, therefore, the volume of products so that, for instance, if no regulated products were produced (since, say, BT divested Openreach) the HR costs would be lower. Such incremental costs should (typically) be recovered from the products to which they are incremental (whether regulated or non-regulated).

2.10 It is also helpful to set out the main components of BT's costs that will form the basis for the current charge controls. These may be broadly categorised as follows:

(a) Incremental to specific products;

(b) Incremental to regulated products as a whole (i.e. common across regulated products such as Ethernet, WBA, WLR and LLU). This report assumes that such costs would be recoverable from the relevant set of regulated products – in other words, a mark-up for a particular product would continue to be applied to ensure

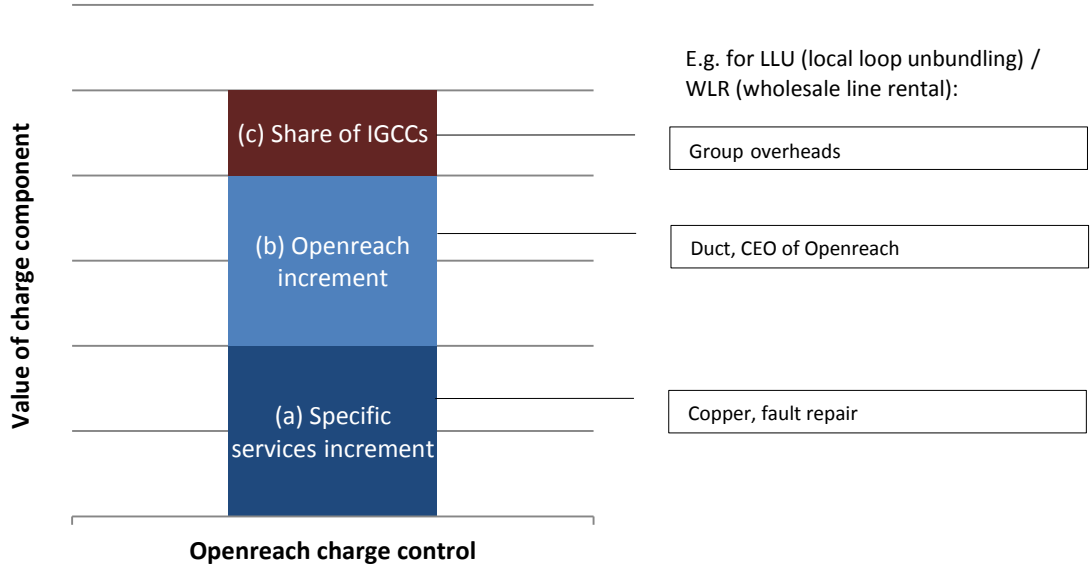
[14] These are the additional cost of providing a defined product / set of products (the "incremental" cost), taking a long run perspective over which all costs are variable.

that costs that are common across the set of regulated products, such as duct costs, are fully recovered from regulated products; and

(c) IGCCs as defined above.

2.11 Ofcom's current charge controls for regulated products include (a) and (b) above, as well as an apportionment of (c) (e.g. based on an allocation approach). This report only deals with how (c) is recovered. This is illustrated in the figure below.

Figure 1: Illustration of main components of a charge control for Openreach



Criteria for assessment

2.12 In examining this issue this report focuses on the potential consequences of recovering IGCCs partly from regulated products (as is currently the case) as compared to recovering none of these from regulated products. This is examined based on the following criteria:

(a) Potential competitive distortions;[15] and

(b) Economic efficiency, in particular:

(i) Productive efficiency, where costs are minimised; and

(ii) Dynamic efficiency, which deals with incentives to invest in quality, innovation and cost minimisation through the most efficient technologies over time.

3 POTENTIAL COMPETITIVE DISTORTIONS

3.1 As a starting point, it is worth noting that Ofcom has often referred to allocative efficiency[16] being maximised when fixed and common costs are allocated across products in inverse

[15] Included in this criterion are potential competitive distortions related to allocative efficiency, where prices are aligned to marginal or incremental costs, in order to ensure consumption decisions lead to maximum benefits.

proportion to the price elasticity of that product/service.[17] Based purely on this "theory", the alternative approach of recovering IGCCs solely from non-regulated products might appear not to maximise allocative efficiency unless regulated products are perfectly elastic (which is unlikely given by definition there are often few, if any, substitutes to these products).

3.2 This theory was originally intended to be applied to the optimal pricing policies of monopolists, and therefore would have been applicable if BT were a monopoly in each of the (horizontal) markets considered. This does not match the facts of this case, where Openreach is a monopolist in the upstream market but is vertically integrated into a competitive downstream market.

3.3 Accordingly, Ofcom's standard theory of common cost recovery is not appropriate here. Rather, explained below, IGCC mark-ups on regulated products can lead to a considerable risk of distortions to retail competition – in particular:

(a) Incentives to expand for BT Group (as a vertically integrated entity) and rival CPs are distorted by the fact that the IGCC mark-up on wholesale charges are a real cash cost for CPs, whereas BT perceives these as a transfer cost netting to zero (i.e. IGCCs drive a "wedge" between the incremental costs faced by BT Retail on the one hand and CPs on the other); and

(b) BT Retail may be benefiting from unique economies of scope derived from BT's vertical integration which an equally efficient CP could not replicate (i.e. BT Retail and CPs may not be competing on a level playing field).

3.4 These are discussed in more detail below.

Distorted incentives to expand due to the IGCCs markup "wedge"

3.5 As a vertically integrated entity, BT Group will perceive any IGCC mark-ups on regulated products differently to rival CPs.

3.6 The principle of EoI means that BT's retail operations in most cases must use the same regulated products that external CPs purchase. Also, Openreach "charges" the same wholesale price (including IGCC mark-up) to BT Retail as it does to other CPs. However, for BT Group as a whole this wholesale charge (and the IGCC mark-up) represents an internal transfer between its divisions, where the net impact (in cash terms) for the Group as a whole is nil. This is distinctly different for other CPs, where the wholesale charge – including the IGCC mark-up – represents a real cash cost.

3.7 This difference (or "wedge") in the marginal costs faced by BT Retail and rival CPs could distort retail competition through its effects on pricing incentives in the retail market. The IGCC mark-up widens this wedge and therefore the potential for retail distortion. This is particularly the case where retail competition is differentiated (as it is in many markets

[16] This is where prices are aligned to marginal or incremental costs, in order to ensure consumption decisions lead to maximum benefits.

[17] See, e.g., Ofcom, "Wholesale mobile voice call termination" consultation, 1 April 2010, §A12.40.

downstream of the business connectivity market, such as the markets for broadband and leased lines), and firms are therefore likely to earn a positive margin.

3.8 Since BT Group faces lower marginal costs than its competitors, it has greater incentives to lower retail prices in order to expand, increasing revenues and profits.[18] An equally efficient non-integrated CP faces a higher marginal cost as a result of the IGCC mark-up in the wholesale charge, and therefore would have smaller incentives to do so.

3.9 Excluding IGCCs from BT's regulated wholesale cost base is therefore likely to substantially lessen these competitive distortions, and boost other CPs' incentives to efficiently compete and expand. This would enable end consumers to choose the retail operator offering the lowest prices driven by incurring the most efficient retail costs.

3.10 Effective competition is likely to result in some proportion of CPs' cost savings from the exclusion of IGCCs being passed through in the form of lower retail price to end consumers. BT Retail's customers would also be expected to benefit from more intensive competition, given BT Retail must respond to the increased risk of customers switching suppliers.

BT Retail may benefit from unique non-replicable economies of scope

3.11 The potential competitive distortions from the "wedge" discussed above could be exacerbated by other unique advantages that BT Retail enjoys as part of a vertically integrated group.

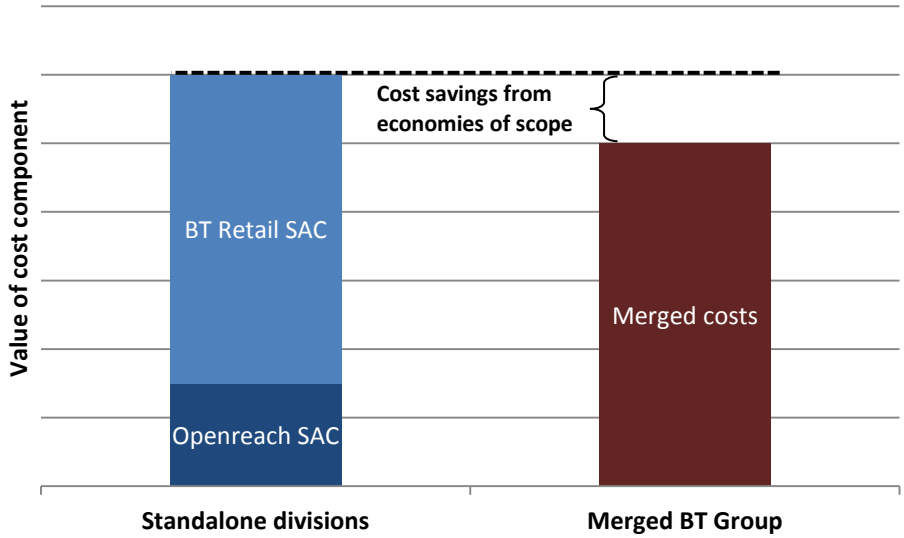
3.12 Vertically integrated businesses such as BT may have economies of scope that rival retail-only competitors cannot replicate. Such economies of scope have also been observed in other industries – for example, Ofwat commented that "[t]*he existence of substantial joint and common costs between the regulated and the unregulated services may suggest that the economies of scope between the two (sets of) service are such that competition for providing unregulated services on a stand-alone basis will be limited*".[19]

3.13 Economies of scope between regulated and non-regulated products could be measured by the difference between the total estimated costs that as standalone businesses (the total standalone costs or "SAC"), and the costs of the merged BT Group. As an illustrative example, the potential economies of scope between BT Retail and Openreach are indicated in the figure below.

[18] If margins were non-positive, BT Retail would in theory be prevented from lowering prices, since this would constitute a margin squeeze. However, in practice there are many uncertainties and estimation issues with applying a margin squeeze test, and its time-consuming nature may mean that even if it were applied correctly, significant competitive harm may have occurred in the intervening period.

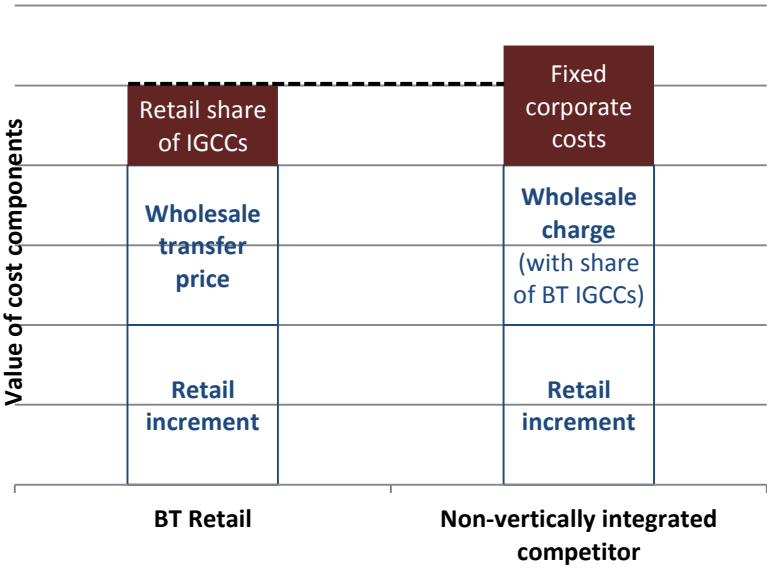
[19] Ofwat, "The treatment of regulated and unregulated business in setting price controls for monopoly water and sewerage services in England and Wales – a discussion paper", October 2010, p.25 http://www.ofwat.gov.uk/future/monopolies/fpl/prs_inf_1010fplregunreg.pdf

Figure 2: Illustration of economies of scope between BT Retail and Openreach



3.14 If BT Retail is able to benefit from any of these economics of scope, then BT Retail may bear a smaller amount of corporate overhead costs (e.g. CEO, human resources, finance and other head office functions) on a per unit basis than an equally efficient non-vertically integrated retail operator.[20] This potentially gives BT Retail a per unit cost advantage, even if both BT Retail and the equally efficient CP incur the same incremental retail costs and were 'charged' the same wholesale price. This is illustrated in the figure below.

Figure 3: Illustrative costs for BT Retail versus an efficient non-vertically integrated operator



3.15 This creates a risk of exacerbating the competitive distortions resulting from the "wedge" described above, by creating the potential to reverse any underlying efficiencies in competitors' incremental costs relative to those of BT Retail. For example, a CP's retail

[20] It may also be possible that BT's per unit IGCC is actually higher than each CP's standalone corporate cost. This is dealt with in section 5, which covers BT's ability to fully recover its IGCCs.

incremental costs could be lower than those for BT Retail, but the size of its advantage may not be sufficient to offset the disadvantage from being required to recover/pay its own corporate costs as well as a share of BT's. This could result in BT retaining a higher market share of customers than would be consistent with its level of efficiency in the retail market, and therefore allocative inefficiency.

3.16 These potential distortions would be avoided if any such economies of scope benefits were allocated to Openreach and not BT Retail, with BT Retail bearing roughly its own standalone cost (SAC). One potential way of implementing this is to allocate no IGCCs to Openreach (as a proxy for regulated products). This is because IGCCs should consist of costs that are truly common to both BT Retail and Openreach (i.e. these would still be incurred even if either BT Retail or Openreach ceased to exist), so that allocating all of these to BT Retail would be the equivalent of allocating a cost saving to Openreach equal to the amount of IGCCs. Reductions in Openreach charges (as a result of not including IGCCs) are also likely to be passed on to end consumers in the retail market through competition between BT Retail and the CPs.

4 PRODUCTIVE EFFICIENCY

4.1 Incentives to minimise costs would be increased by excluding BT's IGCCs from its regulated wholesale cost base. This is because:

(a) In general terms, the smaller the proportion of costs that are passed through (in regulated product charges), the greater the pressures on BT to minimise costs.

(b) More specifically, BT's IGCCs would be exposed in full to the competitive pressures of BT's retail markets, in the same way as those of its non-vertically integrated competitors.

4.2 Under effective competition where prices are not regulated, BT would be strongly incentivised to minimise costs as it can either retain any cost savings as increased margins (potentially for an indefinite period until its competitors catch up), or pass the savings through to consumers via lower retail prices in order to increase its sales. However, under the current approach where some of BT's IGCCs are included in regulated charges and are not exposed to the competitive pressures of its retail markets, BT has lower incentives to minimise these costs since any effort would mostly be passed on to rival CPs after a relatively short period of time (in fact, there are potentially perverse incentives for BT to avoid minimising costs, in order to increase its rivals' costs).

4.3 Although the regulated structure is designed to create incentives for cost minimisation through fixing the price for a number of years, cost minimisation incentives are diluted because cost reductions are passed through into lower charges in subsequent charge control periods. Under regulation, BT keeps some benefit of a cost reduction for the remainder of the current charge control period and partly in the subsequent one (e.g. up to five years).

Conversely, if cost reductions are not passed through into regulated charge, BT will enjoy the full benefit of its cost reduction in perpetuity.[21]

4.4 Such productive inefficiency contributes to raising costs and the retail price floor, where consumers may have otherwise enjoyed lower prices.

5 DYNAMIC EFFICIENCY

5.1 This section considers both: (i) potential dynamic efficiency improvements for BT's competitors due to excluding IGCCs from BT's regulated wholesale cost base; and (ii) the impact this may have on BT's ability to recover its costs and incentives to invest.

Dynamic efficiency improvements

5.2 If IGCCs were excluded from BT's regulated wholesale cost base, potential distortions to competitors' investment decisions could also be reduced. Such decisions may involve a choice between different BT wholesale inputs, or even a choice between using any BT inputs as opposed to self-built inputs.

5.3 The relative price of different regulated wholesale inputs should be an accurate signal of whether CPs should "build or buy" their own inputs. For example, Ofcom has proposed in its Fixed Access Market Reviews consultation to set the price differential between MPF (metallic path facility, the last-mile connection between an end user's location and the distribution network) and WLR/SMPF (shared MPF) inputs equal to the incremental cost differential[22] in order to create incentives to use each regulated product efficiently based on its relative cost.

5.4 Signals could be distorted by how IGCCs are recovered. Ofcom's current fully-allocated cost ("FAC") approach allows for the recovery of IGCCs by allocating these costs on a range of bases, some of which may result in an allocation of common cost that was roughly proportional to the amount of incremental cost incurred by each regulated product. If this were the case, the choice between two regulated products that have different incremental costs would be distorted, where the costlier product would become even more expensive by incurring a higher mark-up. Moreover, the mark-up would also make BT's products more expensive relative to self-build inputs. Accordingly, a "deeper" investment (where TalkTalk invests more in its own network) would become relatively cheaper than a "shallower" investment (where TalkTalk relies more on BT's inputs), where this would not have been the case without the IGCC uplifts.

[21] There are also other reasons why the regulatory regime are unlikely to wholly replicate competitive pressures to minimise costs, including building in existing cost inefficiencies by using actual costs as a starting point, and difficulties in estimating efficiency benchmarks accurately.

[22] Ofcom, "FAMR Consultation: Openreach quality of service and approach to setting LLU and WLR Charge Controls", 19 December 2013, e.g. §1.9ff.

5.5 Consequently, the current approach to IGCC recovery could result in inefficient competitive investment, intended to reduce the allocation of IGCCs to wholesale products purchased by a CP.

BT's ability and incentives to invest

5.6 In order to maintain BT's incentives to invest, BT should have the ability to recover its efficiently incurred costs (including efficiently incurred common costs). Among other factors, BT's ability to recover IGCCs fully would be capped by the equivalent costs incurred by its standalone competitors (i.e. up to the level of "fixed corporate costs" in Figure 3 above).

5.7 However, due to economies of scope (as discussed above), it is highly unlikely that BT's IGCCs plus the retail incremental costs would exceed the SAC incurred by its competitors and therefore BT would be able to recover efficiently incurred IGCCs at the retail level.[23] In other words, provided that BT is as efficient as rivals it will be able to recover IGCCs in non-regulated products since its rivals are not able to gain the same economies of scope.

6 CONCLUSION

6.1 As set out above, the current approach of allocating IGCCs to regulated products could result in competitive distortions and economic inefficiencies. These inefficiencies could be mitigated by adopting the alternative approach of excluding IGCCs from the regulated wholesale charge. In particular, the current approach could result in:

(a) Competitive distortions in the retail market. Ofcom has often referred to allocative efficiency being maximised where prices are set to marginal/incremental costs, with common costs recovered from all products/services in inverse proportion to their price elasticity.[24] However, this economic theory does not apply here, given that BT's vertical integration potentially creates competitive distortions in the retail market. The recovery of IGCCs from regulated wholesale charges drives a "wedge" in various ways between the retail costs for non-vertically integrated operators as compared with BT Retail. This gives BT increased incentives to expand, whereas other operators have dampened incentives to do so;

(b) Productive inefficiency. BT currently has reduced incentives to minimise costs. This is because some costs are currently passed through in regulated charges and BT's benefits from cost reduction are therefore limited. BT's IGCCs are also currently not exposed in full to the competitive pressures of BT's retail markets, unlike the costs of its rivals; and

[23] In the unlikely event that this should happen, it is important to assess whether: (i) if any costs have been misallocated as "common" where they are in fact incremental; (ii) there are actually *diseconomies* of scope i.e. BT Group incurs greater IGCCs as a vertically integrated operator than it would do if these businesses were separate; and (iii) BT is simply productively inefficient. In the last two scenarios BT demonstrates inefficiencies where the excess costs should not be recovered from regulated charges in any case.

[24] See, e.g., Ofcom, "Wholesale mobile voice call termination" consultation, 1 April 2010, §A12.40. This suggests that unless one particular product is perfectly price elastic, common costs should be recovered from all products/services to some extent.

(c) Potential dynamic inefficiency. Regulated product mark-ups may be calculated on an EPMU basis. Doing so could distort "build or buy" decisions by making wholesale products that rely more on BT's inputs appear more expensive.

6.2 **Distortions to competition could be reduced if IGCCs were not recovered from wholesale products**. Specifically, such an alternative approach would:

(a) Remove the "wedge" that the current IGCC mark-up drives between the incremental costs faced by rivals and BT Retail, and therefore increase rivals' incentives to compete and expand;

(b) Increase BT's incentives to minimise costs by exposing its IGCCs in full to competitive pressure in its retail markets. This should lower costs, benefitting end consumers through lower prices (assuming the cost reduction is passed through, which seems likely under effective retail competition);

(c) Reduce any distortions caused by the mark-up to CPs' buy or build decisions; and

6.3 Moreover, **BT should be able to recover its efficiently-incurred IGCCs solely from non-regulated products**, particularly given BT is likely to have unique and non-replicable economies of scope from vertical integration.[25]

[25] In more detail, BT should be able to recover at most the amount of corporate overheads recovered by its competitors under this alternative approach. Any "stranded" IGCCs above this amount should be reassessed to ensure it is not in fact incremental to a particular BT division, or an inefficient BT expense resulting from diseconomies of scope or general productive inefficiency.