OFFICE OF COMMUNICATIONS

Local loop unbundling: setting the fully unbundled rental charge ceiling and minor amendment to SMP conditions FA6 and FB6

Statement

Publication date: 30 November 2005

Contents

Section 1

Summary

Wholesale local access market review

1.1 In the Review of the wholesale local access market, 16 December 2004[1], (the "December statement") Ofcom determined that BT has significant market power ("SMP") in the market for wholesale local access in the UK excluding the Hull Area and Kingston has SMP in the wholesale local access market in the Hull Area. Ofcom imposed certain SMP services conditions on BT and Kingston in those markets and in respect of the provision of co-location. The provision of local loop unbundling ("LLU") services is a specific remedy imposed on BT within the wholesale local access market.

1.2 LLU is a process by which the dominant provider's local loops are physically disconnected from its network and connected to another communications provider's network. This enables competing providers partly or wholly to lease a customer's access line and provide voice and/or data services directly to end users.

1.3 The provision of LLU services is aimed at stimulating competition in the provision of broadband and voice services. LLU services are important because they allow competing providers to innovate, differentiate their product offerings to a greater extent and provide higher bandwidth services, a better range of applications and improved service levels.

Delay setting the fully unbundled rental charge ceiling

1.4 Ofcom deferred setting the charge ceiling for the fully unbundled rental charge when the other LLU charge ceilings were set in December 2004. This was because a high proportion of the total cost of this charge is determined by the cost of laying and maintaining the copper loop, the costs for which Ofcom was in the process of reviewing. Ofcom stated in the December statement that it would determine the fully unbundled rental charge ceiling on completion of the copper cost review. Ofcom published its statement entitled *Valuing copper access* on 18 August 2005[2] and therefore Ofcom is able to set a ceiling for this charge.

1.5 BT voluntarily reduced the fully unbundled rental charge on 1 August 2005 from £105.09 to £80.00. Despite BT's charge reduction, Ofcom still considers it appropriate to set a charge ceiling for this charge in order to ensure that BT's charge is both certain and transparent and that BT is not able to increase it to an excessive level.

---

[1] http://www.ofcom.org.uk/consult/condocs/rwlam/statement

2 http://www.ofcom.org.uk/consult/condocs/copper/value2/statement

The September consultation

1.6 Ofcom published a consultation document proposing a ceiling for the fully unbundled rental charge on 7 September 2005 (the "September consultation"). Ofcom has considered the responses to that consultation carefully and has taken them into account in making its final decision.

Approach to setting the fully unbundled charge ceiling

1.7 Ofcom's approach to setting the fully unbundled rental charge ceiling is the same as set out in the September consultation[3] apart from the exclusion of excess construction costs. The following summarises Ofcom's approach:

- Ofcom has used cost data for 04/05 from BT's regulatory accounts;
- as this charge ceiling applies from January 2006, Ofcom has projected costs for 2005/06 to ensure that the cost data is consistent with the period for which the charge is intended to apply;
- an efficiency factor of 1.5% has been applied to 05/06 operating costs;
- a 10.0% rate of return on capital employed has been applied, as set out in the conclusions of Ofcom's review of BT's cost of capital[4];
- Ofcom has applied a 16% reduction to D-side copper costs to reflect the fact that shorter lines are used to provide broadband services;
- the costs for new drop wire installation for fully unbundled loops are recovered in the rental charge in order to achieve consistency between LLU, wholesale line rental ("WLR") and BT's retail products;
- Ofcom has disallowed some of BT's proposed increase in drop costs and excluded those drop costs which are already being recovered through residential retail charges, in order to ensure no double recovery; and
- Ofcom has removed excess construction costs for which BT charges its customers and WLR service providers separately.

1.8 On the basis of this approach, Ofcom has set the fully unbundled rental charge ceiling at £81.69, which will take effect from 1 January 2006.

Minor amendment to SMP services conditions FA6 and FB6

1.9 SMP services conditions FA6 and FB6, requirement to notify technical information, currently require BT and Kingston to provide 90 days notice of new technical information or before amending existing technical terms and conditions. The Network Interoperability Consultative Committee ("NICC") determines technical specifications with industry consensus and has its own processes for consulting on new, and changes to existing, technical specifications. It therefore appears unnecessary and

---

[3] http://www.ofcom.org.uk/consult/condocs/llu/
[4] *Ofcom's approach to risk in the assessment of the cost of capital,* 18 August 2005, which can be found at http://www.ofcom.org.uk/consult/condocs/cost_capital2/statement/

inappropriate for BT or Kingston to separately provide 90 days notice for these particular specifications, which could cause unnecessary delay.

1.10 Therefore, Ofcom has amended SMP services conditions FA6 and FB6 to carve out technical specifications as determined by NICC from the 90 day notification requirement.

Section 2

Background and introduction

Regulatory framework

2.1 The regulatory framework for electronic communications networks and services is based on five EU Communications Directives[5]. The framework is designed to create harmonised regulation across Europe and is aimed at reducing entry barriers and fostering prospects for effective competition to the benefit of consumers. It was implemented in the UK by the Communications Act 2003 (the "Act").

Wholesale local access market review

2.2 The framework requires national regulatory authorities ("NRAs"), such as Ofcom, to carry out reviews of competition in communications markets to ensure that regulation remains appropriate and proportionate in the light of changing market conditions.

2.3 In the December statement, Ofcom determined that BT has SMP in the market for wholesale local access in the UK excluding the Hull Area and Kingston has SMP in the wholesale local access market in the Hull Area. Ofcom imposed SMP services conditions on BT and Kingston in those markets and in respect of the provision of co-location. The provision of LLU services is a specific remedy imposed on BT within the wholesale local access market.

2.4 LLU is a process by which the dominant provider's local loops are physically disconnected from its network and connected to another communications provider's network. This enables competing providers partly or wholly to lease a customer's access line and provide voice and/or data services directly to end users.

2.5 The provision of LLU services is aimed at stimulating competition in the provision of broadband and voice services. LLU services are important because they allow competing providers to innovate, differentiate their product offerings to a greater extent and provide higher bandwidth services, a better range of applications and improved service levels.

Relevant SMP services condition

[5] Directive 2002/21/EC on a common regulatory framework for electronic communications networks and services
Directive 2002/19/EC on access to, and interconnection of, electronic communications networks and associated facilities
Directive 2002/20/EC on the authorisation of electronic communications networks and services;
Directive 2002/22/EC on universal service and users' rights relating to electronic communications networks and services
Directive 2002/58/EC concerning the processing of personal data and the protection of privacy in the electronic communications sector

2.6 The following SMP services conditions, among others, have been imposed on BT in the wholesale local access market in the UK excluding the Hull Area:

- requirement to provide Local Loop Unbundling Services (SMP condition FA9);
- basis of charges (cost orientation) (SMP condition FA3); and
- requirement to notify technical information (SMP condition FA6).

2.7 The following SMP services condition, among others, has been imposed on Kingston in the wholesale local access market in the Hull Area:

- requirement to notify technical information (SMP condition FB6).

2.8 The requirement to provide Local Loop Unbundling Services requires BT to provide LLU services as soon as reasonably practicable on fair and reasonable terms to all communications providers who reasonably request such services. The condition provides Ofcom with a specific power to issue directions and requires BT to comply with any such directions.

2.9 The requirement to notify technical information requires BT and Kingston to notify new and amended technical information within a reasonable time period but no less than 90 days in advance.

Delay setting the fully unbundled rental charge ceiling

2.10 Ofcom deferred setting the charge ceiling for the fully unbundled rental charge when the other LLU charges were set in December 2004. This was because a high proportion of the total cost of this charge is determined by the cost of laying and maintaining the copper loop, the costs for which Ofcom was in the process of reviewing. Ofcom stated in the December statement that it would determine the fully unbundled rental charge ceiling on completion of the copper cost review. Ofcom published its statement entitled *Valuing copper access* on 18 August 2005.

The September consultation

2.11 Ofcom published a consultation document proposing a ceiling for the fully unbundled rental charge on 7 September 2005. Ofcom has considered the responses to that consultation carefully and has taken them into account in making its final decision.

Section 3

General approach to setting the charge ceiling

3.1 Ofcom's general approach to setting the fully unbundled rental charge ceiling is the same as set out in the September consultation.

Determining charge ceilings

3.2 Determining charge ceilings for specific LLU services constrains BT's ability to set excessive charges that could hinder the development of competition.

3.3 BT voluntarily reduced the fully unbundled rental charge on 1 August 2005 from £105.09 to £80.00. Given this reduction, Ofcom has considered whether it is necessary to set a charge ceiling for this charge and has decided that it is appropriate, in order to ensure that BT's charge is both certain and transparent and that BT is not able to increase its charge to an excessive level. In particular, Ofcom considers that setting this charge ceiling will provide benefits to industry whilst not imposing an undue burden on BT.

3.4 As set out in the December statement and the September consultation, Ofcom considers it preferable to set charge ceilings as opposed to exact charges. In calculating the proposed ceiling, Ofcom has made a number of assumptions, which are set out below. A charge ceiling, as opposed to an exact charge, provides BT with the flexibility to charge below the proposed ceiling in the event that its own assumptions are different to those Ofcom has applied and if costs move over the period in which the ceiling is in place. For example, the implementation of 'equivalence of inputs' for LLU[6] may result in cost reductions and the charge ceiling gives BT the flexibility to reduce its charges to take into account such reductions.

Cost recovery principles

3.5 The application of the principles of cost recovery to LLU costs broadly remains as set out in Section 8 of the December statement. Table 3.1 summarises how LLU per service and system set-up costs should be recovered.

[6] 'Equivalence of inputs' is required pursuant to undertakings given by BT to Ofcom pursuant to the Enterprise Act 2002 and defined in section 2.1 of the undertakings (which can be found at http://www.ofcom.org.uk/telecoms/btundertakings/btundertakings.pdf). It means that BT will supply LLU on the same timescales, terms and conditions (including price) and by the same systems and processes to all communications providers (including its own downstream operations).

Table 3.1: Application of the principles of cost recovery to LLU per service and system set-up costs

	Suggested mechanism of recovery	
Principle	**LLU per service costs**	**LLU system set up costs**
Cost causation	Recovery over LLU lines	Unclear
Distribution of benefits	Recovery over LLU lines	Recovery over all broadband lines
Effective competition	Recovery over all DSL lines	Recovery over all DSL lines
Cost minimisation	Recovery over all DSL lines	Recovery over all DSL lines
Practicability	No suggestion	Recovery over all DSL lines
Reciprocity	No suggestion	No suggestion

Geographically averaged LLU charges

3.6 As stated in the December statement and September consultation, regulated charges can be geographically averaged or vary across the geographic market to reflect differences in the costs of providing services in different areas.

3.7 While de-averaged charges can more precisely reflect the costs incurred in providing LLU services in each area and can provide better signals for investment decision making, there are consumer affordability and significant practicality issues associated with de-averaging charges. Therefore, on balance, Ofcom considers currently that charges for LLU services should continue to be geographically averaged.

LRIC+ methodology

3.8 The December statement imposed on BT a requirement to charge for the provision of Network Access in the wholesale local access market on the basis of long run incremental cost ("LRIC") plus an appropriate mark-up for common costs including an appropriate return on capital employed (SMP condition FA3). An appropriate mark-up could be interpreted as that within a reasonable range determined by parameters such as the incremental cost floor and ceiling.

CCA FAC

3.9 Current cost accounting with fully allocated costs ("CCA FAC") and LRIC+EPMU (equal proportionate mark-ups for common costs) are two different ways of apportioning common costs. While LRIC+EPMU has been preferred in the past, it has the disadvantage of involving a time consuming operation which BT carries out on an irregular basis. Ofcom has little visibility of how BT generates costs from its LRIC model, and this extra iteration by BT of its financial data is not subject to external audit scrutiny. Performance monitoring on a LRIC+EPMU basis against BT's actual financial performance is not straightforward, as routinely prepared wholesale service profitability information is prepared on a CCA FAC basis. By contrast, CCA FAC uses data that can be reconciled to the regulatory financial statements, which have been audited and are in the public domain.

3.10 Given that LRIC+EPMU is not conceptually superior to CCA FAC as a cost basis for setting charges, but that CCA FAC has transparency benefits, Ofcom has used CCA FAC as the appropriate basis for setting the fully unbundled rental charge ceiling (with the exception of certain copper costs as outlined below). This is also the approach that has been adopted for the new network charge controls ("NCCs")[7] and the recent WLR consultation[8].

The regulatory asset valuation

3.11 In the *Valuing copper access* statement, Ofcom concluded that it was no longer appropriate to value BT's pre-1 August 1997 copper access network assets on the basis of CCA FAC (or LRIC+). This was because to do so would have allowed BT to over-recover the costs of those assets which, until 1 August 1997, had been valued under the HCA convention. In order to avoid the potential for such over-recovery, and given that it is unlikely that any operator will build a new nationwide access network in competition with BT in the near future, Ofcom decided to create a regulatory asset value, or RAV, to represent the remaining value of the pre-1997 copper access network assets rather than continuing to value those assets at their current cost. The value of the RAV is set to equal the closing historical cost accounting value for the pre-1 August 1997 assets for the 2004/5 financial year and its value will be increased each year by the Retail Price Index ("RPI") to ensure it is not eroded by inflation. Over time the RAV will gradually disappear as the pre-1997 assets are gradually replaced with new ones. Post-1 August 1997 assets which have been valued consistently on a CCA FAC basis throughout their lives will continue to be valued using the CCA convention.

3.12 Therefore, the part of the LLU charge which reflects recovery of the costs of the local loop will reflect an average of the costs associated with pre-1 August 1997 assets, based on the RAV, and the costs associated with post-1 August 1997 assets, calculated using CCA FAC as described above. The other components of the fully unbundled rental charge are based on CCA FAC.

BT cost data

3.13 At the time the other LLU charge ceilings were set in December 2004, BT did not have sufficiently disaggregated regulatory accounting data that would have enabled such data to be used in charge setting. Ofcom considers that it is more appropriate to use regulatory accounting data where available. BT has provided 04/05 regulatory accounting cost data for the fully unbundled rental charge. Using this data means that the rental charge ceiling will not be set on an entirely consistent basis to the other LLU charge ceilings set in December, which included the shared rental charge

[7] http://www.ofcom.org.uk/consult/condocs/charge/statement/#content Consistency with the NCCs is important to avoid over or under-recovery of costs in aggregate.
[8] http://www.ofcom.org.uk/consult/condocs/wlrcharge/

and full and shared connection charges[9]. However, given that it is generally more appropriate to use this data where available, and Ofcom is likely to move all LLU charges to a regulatory accounting basis when they are next determined, Ofcom has used this data to set the fully unbundled rental charge ceiling.

Rate of return on capital employed

3.14 The appropriate rate of return that should be included in the charges for LLU services is the cost of capital BT is currently allowed on its regulated network activities. This cost of capital is equal to the weighted average cost of capital for the activities assessed using the capital asset pricing model.

3.15 Ofcom has recently conducted a review of BT's cost of capital. The statement entitled *Ofcom's approach to risk in the assessment of the cost of capital* sets out the conclusions of this review. In particular, it concludes that the appropriate rate of return on capital employed for BT's access network is 10.0%. This percentage has been used in setting the fully unbundled rental charge ceiling.

Charge control

3.16 In response to movements in costs, and hence charges, over time, Ofcom can either re-determine charges or set a charge control. Charges that are re-determined regularly have a number of positive properties, but provide the dominant provider with limited incentives towards cost minimisation and provide little predictability for competing providers. To ensure that charges better reflect those that could be expected in a competitive market, it may be appropriate to introduce a charge control. In general, a charge control constrains the movement of regulated charges so that they reflect any cost savings derived from expected volume increases, expected reductions in asset and input prices and expected efficiency improvements (assessed through a benchmarking exercise). At the same time, a charge control allows the retention of all gains from unanticipated efficiency improvements for the period of the control, thus providing the dominant provider with incentives towards cost-efficiency.

3.17 When LLU charges were first set, a charge control was not introduced because of the inevitable uncertainty surrounding the charging of services not yet in place. At the time of the December statement, Ofcom was of the view that current take-up of LLU services was too limited to allow an accurate enough assessment of LLU costs to set a sufficiently robust charge cap. Currently, the possible implementation of 'equivalence of inputs' adds uncertainty to the costs. Therefore, Ofcom intends to review the issue of a charge control in the next review of the wholesale local access market and intends the charge ceilings to remain in place until such time.

---

[9] 04/05 regulatory accounting data was not used in the network charge control review because this data is already affected by PSTN rundown and replacement by next generation networks. This does not affect the access network and therefore there is not a consistency issue.

Section 4

Specific approach to the cost categories

4.1 Ofcom's approach to the cost categories of the fully unbundled rental charge is the same as set out in the September consultation apart from the exclusion of excess construction costs. This is explained in detail below.

Cost categories of the fully unbundled rental charge

4.2 The following cost categories are included in the fully unbundled rental charge:

- **E-side and D-side capital and maintenance** – the exchange side (E-side) and distribution side (D-side) infrastructure, which were considered in the valuing BT's copper access review;
- **MDF capital and maintenance** – the equipment where local loops terminate and cross connections to competing providers' equipment can be made;
- **Drop capital and maintenance** – the drop wire from the street to the customer premises;
- **Selling and general administration costs** – these costs are the administrative costs BT incurs in providing a fully unbundled loop; and
- **Test access matrix (TAM) & line test costs** – the TAM provides a remotely-controllable facility for the temporary connection of a line to the line test system to facilitate fault investigation tests.

Assumptions applied to the cost categories

4.3 The assumptions used for each of the cost categories are set out below. In each case, BT has provided Ofcom with cost data for 04/05 from its regulatory accounts, unless stated otherwise.

4.4 Under each cost category set out below, Ofcom has assessed BT's cost data and made adjustments to ensure that:

- only relevant costs are included;
- no double counting takes place; and
- costs are based on efficiently incurred cost levels.

Forecasting costs

4.5 As this charge ceiling is intended to apply from January 2006, Ofcom has based the charge ceiling on projected costs for 05/06 to ensure that the cost data is more consistent with the period for which the charge is intended to apply. For those costs not covered by the copper access review, an RPI of 2.5% has been applied to 04/05 operating costs submitted by BT to calculate 05/06 costs.

4.6 Given that this charge ceiling is likely to apply for a period of around two years, until the next market review, Ofcom has considered whether it is appropriate to base the charge on the average projected costs for 05/06 and 06/07. Alternatively, the ceiling could be indexed which would operate similarly to a charge control. Given the uncertainties involved with forecasting the costs for the implementation of 'equivalence of inputs' and likely efficiency savings, Ofcom has only forecast costs for 05/06. If there was a material change in costs that affected this charge significantly, Ofcom would consider whether it was necessary to re-determine the charge ceiling in advance of the next market review.

4.7 An efficiency factor has been applied to 05/06 operating costs. Ofcom has based the calculation of its efficiency factor for LLU on the operating costs (excluding depreciation) of the access network between 01/02 and 03/04, excluding costs relating to LLU and connection components. Ofcom has assumed that BT will be able to achieve the same underlying rate of real unit cost reduction over the period to 05/06 as it has over the period 01/02 to 03/04. The average real unit cost reduction over the period is calculated after accounting for volume changes, excluding catch up of BT's inefficiency at the start of the period and including the expected catch up of BT's inefficiency over the next six years (04/05 to 09/10). The data for BT's past and current levels of inefficiency are provided by various studies conducted by NERA on behalf of Ofcom[10]. This is consistent with the calculations for the NCCs.

4.8 Ofcom's calculations suggest a range for the underlying reduction in real unit costs of 0.9% to 4.0% per annum, depending on the cost-volume elasticity, the extent of inefficiency assumed to exist in 03/04 and the period over which this is assumed to be eliminated. As in setting the NCCs, Ofcom has applied a degree of judgement to ensure that the value calculated is a reasonable target going forward. As a result of this Ofcom believes it is appropriate to adopt a figure in the lower half of the range and believes an annual rate of efficiency gain of 1.5% to be reasonable.

4.9 BT has submitted that its expected increase in non-domestic rates should be explicitly recognised in any forecast. Ofcom does not consider that specific changes in costs should be included without being able to review all the cost items to determine known decreases as well as known increases in costs.

Responses to the September consultation

Forecast period

4.10 BT does not consider that the use of 05/06 costs on which to base the charge ceiling is appropriate, given that the charge ceiling is intended to apply until around December 2007. BT suggests that Ofcom should review the charge ceiling in 12 months or consider a charge control for the period up to March 2008. BT argues that Ofcom's approach will provide no transparency that the fully unbundled rental charge is cost orientated for 06/07 and beyond. Telewest also considers that an RPI should be applied beyond the first year and that Ofcom should commit to an early review of the charge ceiling based on actual numbers and more stable forecasts.

[10] http://www.ofcom.org.uk/consult/condocs/charge/main/nera.pdf

Ofcom response

4.11 Ofcom has considered both forecasting costs beyond 05/06 and setting a charge control. However, as set out above, Ofcom is of the view that at present costs are not sufficiently stable to forecast costs beyond 05/06 or for a charge control to be imposed, especially given that charge controls are generally set for a period of four years. Further, as BT's charge is currently below the charge ceiling, BT is able to set a cost oriented price at or below the ceiling without needing to revert to Ofcom. As such BT has some flexibility to both increase and decrease its prices in line with cost movements. If in the future BT believes that it is no longer able to materially recover its relevant costs and charge below the ceiling, then it should make representations to Ofcom that a review of the ceiling is necessary.

RPI

4.12 BT considers that Ofcom should use the actual increase in RPI over the last 12 months which is 3.0%.

Ofcom response

4.13 In the *Valuing copper access* statement, Ofcom explained that it had calculated the RAV for 2005/06 on the basis of an average RPI of 2.5% over the year and that it intended to incorporate the conclusions of that review in the normal cycle of price reviews of the relevant products, starting with the fully unbundled rental charge ceiling. Ofcom has therefore based this charge ceiling on the value of the RAV as set out in the *Valuing copper access* statement. Ofcom believes that 2.5% remains a reasonable assumption for RPI in 2005/06. At the end of each financial year, the RAV will be recalculated on the basis of the actual rate of RPI in the financial year, on a backward looking basis. The impact of actual RPI rates will therefore be reflected when prices are set for future periods.

4.14 For reasons of consistency, Ofcom considers that the same RPI should be applied to non-copper costs to avoid copper and non-copper costs in the same charge being forecast on a different basis.

Efficiency factor

4.15 BT considers that an efficiency factor of 1.5% is very challenging and that a lower assumption should be used. BT considers that, at a minimum, a review of this figure should be undertaken well in advance of 2007/08. Telewest also considers that the efficiency factor of 1.5% will be challenging, especially given BT's known increase in non-domestic rates.

4.16 UKCTA and C&W suggest that the NERA report may not provide the best view of BT's efficiency in its local loop, as the local loop is likely to be less efficient than BT as a whole. UKCTA and C&W consider that the 1.5% efficiency adjustment is insufficient and that Ofcom should undertake some work to specifically consider the efficiency of BT's local loop operations. Easynet would also expect to see a greater efficiency factor than 1.5% applied.

Ofcom response

4.17 The assumption of a 1.5% annual rate of reduction in BT's real unit access costs is based on a number of factors, only one of which is the NERA study. In particular, Ofcom has estimated the underlying rate of reduction in real unit access costs which BT has achieved in the past, and has used this to inform its assumption about the rate at which it will be able to do so in the future. In addition, the estimate of BT's average efficiency relative to the United States local exchange companies (LECs) calculated by NERA has also been used in deriving an appropriate assumption for efficiency gains in BT's core network. This is reflected in the NCCs and it is important that the assumptions used in setting the LLU ceiling are consistent with this. Lastly, in selecting the final value of the efficiency factor a degree of judgement needs to be applied to ensure that the value calculated is a reasonable target going forward. Ofcom notes that BT and Telewest consider the target challenging while others believe it to be not challenging enough. On balance, Ofcom considers that a 1.5% annual rate of real unit cost reduction is a reasonable assumption for BT's access network.

4.18 In response to BT's comment regarding an early review of this efficiency factor, if in the future BT believes that it is no longer able to materially recover its relevant costs and charge below the ceiling, then it should make representations to Ofcom that a review of the ceiling is necessary.

Increases to costs

4.19 Telewest considers that Ofcom should take a more consistent and realistic forward-looking approach by including increases to non-domestic rates and additional costs that will be incurred with the implementation of equivalence. UKCTA and Easynet consider that increases to non-domestic rates should not be included in the charge without a review of all costs.

Ofcom response

4.20 As set out above, Ofcom is of the view that specific changes in costs such as increases to non-domestic rates should not be included in the cost model for this charge, without Ofcom being able to review all costs items to determine both increases and decreases of costs. As such, Ofcom does not consider it appropriate to include increases in non-domestic rates in the charge ceiling. Further to this, and as set out above, the ceiling constraint provides BT with some flexibility to both increase and decrease its prices in line with cost movements.

4.21 Ofcom considers that it has taken into account the implementation of equivalence in its assessment of costs.

E-side and D-side capital and maintenance

4.22 The *Valuing copper access* statement sets out the methodology that has been adopted in valuing the E-side and D-side costs of the access network. Taking into account the new weighted average cost of capital for BT's access network, as set out in Section 3, the statement concludes that a reasonable estimate of these costs for LLU is £60.11 per line for the financial year 2005/6.

4.23 For the purposes of determining E-side and D-side costs relevant to LLU, Ofcom has adjusted these costs on the basis of line length. BT has provided data which suggests that currently the average length of a copper loop that can be used to provide a 2Mbit/s broadband service is approximately 19% shorter than the average copper loop. This situation arises because DSL does not technically work over long line lengths and full LLU is mainly used to provide broadband, and broadband and voice services, but not voice only services. It is unlikely that line lengths constraining the provision of DSL will occur on the E-side and therefore Ofcom has only adjusted the D-side costs to reflect shorter loop lengths for broadband services.

4.24 The choice of a line length reduction figure is difficult, as there is no precise data available. Therefore, Ofcom considers that it is appropriate to be cautious in this area and only apply a 16% reduction to D-side costs. This lower figure takes into account lower bandwidth broadband services, for example a 512kbit/s broadband line will be able to use a longer line length. It also takes into account technological advances that may mean higher bandwidth services are available over longer line lengths by 2005/06.

4.25 In the future, if fully unbundled loops are used to provide voice only services, then the rationale for using a shorter loop length may become less valid and this assumption may need to be revisited.

Responses to the September consultation

Line length adjustment

4.26 BT considers that Ofcom has not given sufficient consideration to the longer-term implications of a line length adjustment. Ofcom should recognise the fact that the average length of an LLU line is likely to increase over time and commit to review this assumption in 12 months time.

4.27 Telewest disagrees in principle with the use of a line length adjustment and the data used. Telewest questions whether Ofcom's approach is consistent with BT's obligation to not geographically discriminate in its pricing of telephony line rental, given that, if the LLU charge is lower than average, then the WLR and BT retail charges will be higher than average. This implies that customers would be penalised for the fact that LLU lines tend to be located in urban areas. Telewest believes that the imminent role out of ADSL2+ will increase the average broadband loop length and therefore the current data is not a fair reflection of 05/06 average distances. Telewest also questions whether all D-side costs are distance related.

4.28 UKCTA and Easynet consider that the line length adjustment should be greater than 16%, and in the region of 25-35%, because LLU operators are likely to offer faster products than BT and tend to concentrate their roll out on densely populated urban and suburban areas.

Ofcom response

4.29 Ofcom considers that the line length adjustment has no implications for the requirement on BT to geographically average its retail line rental charges. Ofcom agrees that, if the average cost of LLU lines is below the average for all lines, then the average cost of the remaining lines must be higher than the average of all lines. However, the line length adjustment is based on a technical assessment of the average length of lines which can feasibly be used for broadband rather than an assumption about the actual average cost of LLU lines based, for example, on an assessment of the probable locations of LLU customers. There is of course no effect on the average length of lines which can feasibly be used for narrowband services, to which the requirement to geographically average applies.

4.30 Ofcom accepts that there are some costs of the D-side plant which do not vary with distance, such as the plant and labour associated with the installation of the distribution point. However, Ofcom considers that in the majority of cases the length of the D-side section will be such that the variable costs of plant and labour related to distance will significantly outweigh the fixed costs related to the distribution point. Therefore, Ofcom considers that D-side costs are, on the whole, distance related.

4.31 Having considered the responses received that this adjustment should be both higher and lower, Ofcom considers that, on balance, a 16% line length adjustment remains appropriate. Ofcom recognises that the difference in line lengths between narrowband and broadband is likely to reduce over time. Again, if BT considers that this adjustment proves inaccurate and results in BT being no longer able to materially recover its relevant costs and charge below the ceiling, then it should make representations to Ofcom that an early review of the ceiling is necessary.

Fault rates

4.32 BT considers that the charge ceiling should reflect the higher costs of maintenance for broadband lines as compared to narrowband lines. BT points out that this was the approach taken by Ofcom in December 2004 when the shared rental charge ceiling was set.

Ofcom response

4.33 BT has presented data that indicates a 32% higher incidence of faults on broadband lines. Ofcom has considered whether this should be reflected in a higher charge ceiling in the light of its cost recovery principles as set out in Table 3.1. Cost causation suggests that the higher fault rate should be reflected in higher maintenance costs being allocated to broadband lines. However, the distribution of benefits criterion suggests that maintenance costs should be averaged across both narrowband and broadband lines, as all lines benefit from the reporting and repair of broadband faults. This is for the following reasons:

- it is likely that broadband faults would at a point in the future have been reported on voice lines, given that voice lines share a common infrastructure with broadband lines (D-side and E-side cable assets);
- in general, broadband services are more sensitive to faults and therefore faults that affect both narrowband and broadband are more likely to be reported first as a broadband fault. The nature of the technology employed for broadband services means that it is less tolerant of noise or attentuation on the line than narrowband services. Additionally, broadband services use equipment which can provide the end user with objective measurements of performance, such as transmission speed, making it more likely that an end user will report a fault if, for example, data throughput falls due to a degraded signal-to-noise ratio on the line. Such a degradation would need to be comparatively much more severe to be noticed by a narrowband user. Thus, many common faults which degrade service rather than disable service, such as ingress of moisture or dirty contacts as opposed to a line

break, are more likely to result in a fault report from a broadband user before the service degrades to a point where a narrowband user of the same plant would report a fault; and

- as the repair of many faults inevitably involves the repair or replacement of infrastructure used by voice and broadband lines, for example cable and joints, the repair of broadband faults will also benefit narrowband infrastructure and create a more resilient network for voice.

4.34 The other cost recovery principles do not provide strong guidance.

4.35 Further, it is currently not clear how stable BT's data is over time and whether the current fault rate is reflective of future fault rates.

4.36 On balance, Ofcom considers that it is more appropriate to average these costs over all lines but will consider this issue again when the charges are next reviewed and more data is available. Ofcom will also ensure that the rental charges for both full and shared access are set on a consistent basis at that time.

4.37 The *Valuing copper access* statement wrongly stated that the £60.11 took into account differing fault rates. The £60.11 copper cost figure is actually calculated based on averaged maintenance costs but takes into account the presence of Digital Access Carrier System (DACS) equipment on some WLR loops[11].

MDF capital and maintenance costs

4.38 The costs associated with MDF capital and maintenance have been spread over all loops which use the MDF to give a unit cost. For each specific product, BT has calculated costs using the unit cost multiplied by a usage factor. Those products that use more of the MDF than others are allocated more of the costs and therefore LLU takes a greater proportion of MDF costs compared to PSTN services. Ofcom considers that BT's costs and approach appear reasonable.

Drop wire capital and maintenance costs

4.39 The costs for drop wire installation for fully unbundled loops were previously recovered in the new provide connection charge. In order to achieve consistency between LLU, WLR and BT's retail products, these costs are now recovered in the fully unbundled rental charge. A consistent treatment of drop costs between these products will reduce incentives for arbitrage, such as where LLU providers may encourage customers to request a new line from BT and then immediately transfer the line to them. Consistency also reduces the risks of over-recovery where there is churn between products. For example, previously, a move from full LLU to WLR would have meant drop costs being paid upfront in the LLU new provide connection charge and then again through the WLR rental charge.

4.40 To reflect this change, BT has notified a new connection charge for fully unbundled new provides which will apply from 15 December 2005.

[11] DACs equipment allows two voice lines to share the same loop.

4.41 BT has submitted that the LLU charge should contain an allowance for the capital costs of existing drop wires. The accounting data for 2004/05 only partly reflects these costs because the accounting treatment of drop wire costs was changed in 2000/01. Prior to this, drop wires were expensed (written off in the year incurred). Since 2000/2001 drop wires have been capitalised and written off over a ten year period. BT has proposed “normalisation” of the 04/05 data to include the full cost of drop wires and has assumed a 50% increase in capital costs in an attempt to reflect in LLU charges the position that the new accounting treatment of drop wires will show in 2010/11. Ofcom considers that this adjustment is inappropriate because the treatment of drop wire costs before 2000/2001 means that all capital expenditure on drop wires in this period has already been recovered. The normalisation adjustment proposed by BT would therefore result in the over recovery of the costs of pre 2000/2001 drops.

4.42 Moreover, to allow, in the charges, recovery of all the undepreciated portion of the costs of post 2000/2001 drop wires would also appear to result in over-recovery of these costs. This argument follows from treating drop wire costs as expensed in the modelling carried out in the 2001/2002 retail price control review which resulted in the setting of the current RPI-RPI retail price cap[12]. The level of retail prices controlled by the retail price cap allows for the recovery of the operating and capital costs of drops installed for BT retail residential customers during the price control period. Since the recovery of the capital costs of all existing residential drop wires has already been allowed for in retail prices, only the drop wire costs for business and future new provide LLU connections and the recurring operating costs for LLU residential drop wires should be included in the LLU rental charge for as long as the retail price control applies. Whether this approach remains appropriate beyond the retail price control period may depend on whether another retail control is put in place and, if so, the costs which are deemed to be recovered from retail customers for the purposes of setting it. Any subsequent charging regime should allow for the recovery of reasonable costs from retail, LLU and WLR customers in a consistent way and therefore it may be necessary to re-visit this charge ceiling if current circumstances materially change.

4.43 The capital cost of business LLU drop wires has been calculated on the basis that 5% of LLU transfers are business lines. Ofcom has calculated 05/06 costs by adding a further year’s worth of depreciation and return on capital employed to BT’s 04/05 costs.

4.44 The drop wire costs for future LLU new provides have been calculated on the basis that 15% of LLU connections are new provides. BT has provided the depreciation and return on capital employed costs associated with a new drop wire. Ofcom has included 15% of these costs to reflect the number of LLU new provides that there are likely to be in a year.

4.45 Regarding the recurring operational costs and drop wire maintenance costs, BT has spread these costs across all drop wires to determine the unit cost.

[12] http://www.ofcom.org.uk/static/archive/oftel/publications/whole_line/2002/pcr0602.htm

Responses to the September consultation

Rebate

4.46 UKCTA, C&W and Easynet consider that BT should not be able to over-recover drop wire costs and therefore BT should pay a rebate for already installed new provide lines.

4.47 BT does not intend to offer rebates to those LLU operators who have already purchased LLU new provide lines.

Ofcom response

4.48 Ofcom has analysed the drop costs included in this charge ceiling and the costs for already installed new provide lines are not included (only the cost of future new provide drops are included). Ofcom is satisfied that BT is not over-recovering costs in this respect and therefore a rebate is not necessary.

Cost recovery approach

4.49 BT believes that Ofcom's approach to the recovery of drops and in particular the exclusion of residential drop wires mixes two regulatory issues in that regulation at the retail level is being used to affect prices at the wholesale level. BT does not consider that it is appropriate for any wholesale costs to be met by BT's retail customers and that the principles of cost orientation should be followed. In addition, the current retail price control period ends on 31 August 2006 and therefore Ofcom should review the charge ceiling in 12 months. BT requests that Ofcom sets out its views on the appropriateness of costs incurred by Openreach being recovered by revenues earned by BT Retail after the expiry of the current retail price control.

Ofcom response

4.50 The principles of cost recovery reflect the assumption that there should be no double recovery of costs. As such, because the current retail price control includes the full costs associated with residential drop wires, to include them in this charge would result in an over recovery of these costs. At present, the precise timing of the retail price control review has yet to be determined. If there is a change to this control and BT is no longer able to materially recover its relevant costs and charge below the ceiling, then it should make representations to Ofcom that an early review of the ceiling is necessary.

4.51 Any change in the internal structure of BT will not alter the principles of cost recovery and the need to ensure that BT does not over-recover its costs.

New provides

4.52 BT considers that the 15% figure for the number of new provides as a percentage of all connections is too low given that the current percentage is 35% and will be unlikely to drop by such an extent by the end of 2005/06. Again, BT would like this assumption reviewed in 12 months.

4.53 Telewest considers that Ofcom should not use a forecast figure, as opposed to an actual figure, for the number of new provides as a percentage of all LLU connections, without using appropriate forecasts for the line length adjustment and taking into account increases to BT's business rates.

4.54 UKCTA and C&W consider that the 15% figure for the number of new provides as a percentage of all LLU connections is too high. They consider that the current high figure of 35% has arisen because of the lack of a sufficient re-activation product, where current estimates suggest that as many as 54% of new provides could have been achieved using reactivation. BT has now agreed to a new re-activation product and therefore UKCTA and C&W expect the volume of new provides to significantly decrease. They also consider that the current 35% figure will also reduce as confidence in LLU grows and users make use of existing lines as opposed to installing new lines.

4.55 Easynet also expects the number of new provides to drop significantly over time and suggests that the calculation is re-visited on a yearly basis to ensure that there is no under or over-recovery as the number of LLU services move from low volume, high value, business numbers to the mass market.

Ofcom response

4.56 Ofcom has considered the responses received and the arguments that the percentage figure for new provides should be both lower and higher. On balance, Ofcom considers that 15% remains a reasonable estimate of new provides as a percentage of total LLU connections for 2005/06.

Business lines

4.57 BT considers that the 5% figure for the number of business lines as a percentage of all lines is too low. Telewest also considers that the 5% figure for the number of LLU business lines as a percentage of LLU transfers is low given that the UK Broadband Status Report published by Ovum quotes 21% of all ADSL broadband customers are business customers.

4.58 UKCTA considers that the 5% figure for the number of business lines as a percentage of all LLU lines is too high. UKCTA argues that, because LLU was initially targeted at business customers, current figures show a high number of business customers. However, the expected growth of LLU is in the residential market. Easynet expects the proportion of business lines to be nearer 2%, as the mass market consumer ISPs move to LLU.

Ofcom response

4.59 Ofcom has considered the responses received and the arguments that the percentage figure for business lines should be both lower and higher. On balance, Ofcom considers that 5% remains a reasonable estimate of business lines as a percentage of LLU transfers for 2005/06.

Selling and general administration costs

4.60 It is appropriate to include the wholesale costs incurred by BT in providing LLU. These costs include relevant systems costs and costs for activities such as billing and customer support, all of which are required to support LLU.

4.61 BT has not been able to provide regulatory accounting data for these selling and administrative costs but has estimated what these costs are likely to be following the implementation of equivalence of inputs. BT has based its estimates on the equivalent costs of its own broadband services and the costs it expects to incur in providing new systems. Ofcom considers that this is a reasonable approach to estimating costs going forward.

TAM and line test costs

4.62 The costs of the LLU TAM and PSTN line test costs have been pooled together and spread over all lines.

Fully unbundled rental charge ceiling

4.63 On the basis of the proposed approach, set out above, Ofcom has imposed a charge ceiling for the fully unbundled rental charge of £81.69, which will take effect from 1 January 2006.

4.64 As set out above, for the purposes of calculating the charge ceiling, Ofcom considers it appropriate to base the value of BT's pre-1 August 1997 copper access network assets on the value of the RAV set out in the *Valuing copper access* statement. The reasons for the adoption of the RAV are set out in full in that statement. Given that BT's pre-1 August 1997 copper access network assets account for a significant proportion of the costs that make up the proposed charge ceiling, the charge ceiling itself cannot be said to be 'based' on LRIC+. On the face of it, the charge ceiling is therefore not consistent with SMP Condition FA3.1, imposed on BT in December 2004, which requires BT to ensure that its charge for Network Access in the wholesale local access market are 'based' on LRIC+. For this reason, Ofcom has included specific wording in the Direction setting the charge ceiling to make it clear that the obligation in SMP Condition FA3.1, to ensure that BT's charges are based on LRIC+, will not apply in respect of the charge ceiling.

Responses to the September consultation

4.65 Telewest suggests that Ofcom set a charge floor as well as a ceiling and monitor BT's charge to ensure that it is not predatory. Telewest request that Ofcom state whether the charge is consistent with the Competition Act.

Ofcom response

4.66 In telecoms markets, the conventional cost floor below which prices are regarded as potentially anti-competitive (where the operator has SMP) is equal to LRIC. Any price above LRIC will result in sales of the service in question making some contribution to the recovery of common costs (costs which would be incurred even if that service were not produced) and may therefore be rational in the absence of any anti-competitive motive or effect.

4.67 Cost floors for network components, including those used to provide LLU, based on LRIC are shown in BT's financial statements. These are intended as a first-order test for anti-competitive pricing. A comparison of the LLU charge with the floors for the relevant components does not suggest that BT's current price is below the cost floor.

Communications Act tests

4.68 Ofcom considers that the Direction (at Annex 1) meets the tests set out in the Act.

4.69 Ofcom has considered its duties under section 3 and all the Community requirements set out in section 4 of the Act. In particular, the Direction is aimed at promoting competition and securing efficient and sustainable competition for the maximum benefit of retail consumers by ensuring that charges for LLU services are at a level that enables providers purchasing those services to compete in downstream narrowband and broadband markets.

4.70 Section 49 of the Act requires directions to be objectively justifiable, non-discriminatory, proportionate and transparent. Ofcom considers that the direction is an objectively justifiable and proportionate response to BT’s market power, as it ensures that BT is unable to exploit its market power and enables competing providers to purchase services at levels that enable them to compete in downstream markets to the benefit of consumers, whilst at the same time allowing BT a fair rate of return that it would expect in competitive markets. Although the direction is only made against BT, it does not unduly discriminate, as Kingston does not currently provide LLU services. Finally, it is transparent in that it is clear in its intention to ensure that BT provides LLU services at cost oriented charges.

Section 5

Minor amendment to SMP conditions FA6 and FB6: requirement to notify technical information

Introduction

5.1 Ofcom is using the opportunity of this document's publication to make a change to SMP services conditions FA6 and FB6, requirement to notify technical information, which were imposed on BT and Kingston in December 2004 when the wholesale local access market review was completed.

5.2 These conditions require BT and Kingston to notify new technical information at least 90 days in advance of providing new wholesale services or amending existing technical terms and conditions to ensure that LLU operators are given sufficient time to prepare.

Technical changes determined by the Network Interoperability Consultative Committee (NICC)

5.3 NICC is a UK communications industry committee which acts as an industry consensus group in which specifications and technical issues associated with network competition can be discussed.

5.4 NICC deals with particular issues via its interest groups, which aim to represent particular sectors of the industry. They include representatives of network operators, public exchange manufacturers, terminal equipment suppliers and service providers. There is also a separate users' panel which works electronically to provide a user perspective on NICC activities.

5.5 NICC only determines technical specifications with industry consensus and has its own processes for consulting on new, and changes to existing, technical specifications.

The amendment

5.6 Given that industry is already involved in an appropriate consultative process for NICC technical specifications, it appears unnecessary and inappropriate for BT or Kingston to separately provide 90 days notice before introducing these new or amended technical specifications, which will add unnecessary delay.

5.7 Therefore, Ofcom has amended SMP services conditions FA6 and FB6, requirement to notify technical information, to carve out technical specifications as determined by NICC from the 90 day notification requirement. The modifications are set out at Schedules 1 and 2 of Annex 2 of this consultation document. The SMP services condition, requirement to notify technical information, is set out at Annex 3.

No material change to the relevant markets

5.8 Ofcom is empowered under section 86 of the 2003 Act to modify existing SMP services conditions without carrying out a market review. To do so, Ofcom must be satisfied that there has been no material change in the relevant markets since the condition was set or the SMP determinations were made in December 2004. Ofcom is satisfied that there has been no such material change and its analysis is set out in Annex 4.

Responses to the September consultation

5.9 All respondents supported the proposed amendments.

Communications Act tests

5.10 Before amending an SMP services condition, Ofcom must satisfy the requirements set out in section 47(2) of the Act. In addition, Ofcom must consider and act in accordance with its general duties under section 3 of the Act and the six Community requirements in section 4 of the Act.

5.11 Section 47(2) requires modifications to be objectively justifiable, non-discriminatory, proportionate and transparent. The modifications are objectively justifiable, in that they remove notification requirements which would unnecessarily delay the introduction of new and amended technical specifications as determined by NICC. They are proportionate, as they remove the notification requirements on BT and Kingston where they are not necessary. They do not unduly discriminate as the same modification applies to both BT and Kingston. Finally, they are transparent in that they are clear in their intention to ensure that BT and Kingston introduce new and amended technical specifications as determined by NICC without notifying them in advance.

5.12 Ofcom has considered its duties under section 3 and all the Community requirements set out in section 4 of the Act. In particular, the modifications are aimed at promoting competition and securing efficient and sustainable competition for the maximum benefits of consumers by ensuring that BT and Kingston introduce new and amended technical specifications as determined by NICC without any delay.

Annex 1

Direction: setting the fully unbundled rental charge ceiling

Direction under section 49 of the Communications Act 2003 and SMP Services Conditions FA3.1 and FA9.2 imposed on BT as a result of the market power determination made by OFCOM that BT has significant market power in the market for wholesale local access services within the United Kingdom, but not including the Hull Area

WHEREAS:

A. On 16 December 2004, in accordance with Section 79(4) of the Act, Ofcom published a Notification identifying the wholesale local access market in the UK excluding the Hull Area and making a market power determination that BT has significant market power in respect of that market;

B. On 16 December 2004, in accordance with Section 48(1) of the Act, Ofcom published a Notification setting certain SMP conditions on BT to take effect on 16 December 2004, including SMP Condition FA3, which requires BT to secure that its charges are reasonably derived 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, and SMP Condition FA9, which requires BT to provide specific LLU services on fair and reasonable terms, conditions and charges as Ofcom may direct from time to time;

C. This Direction concerns matters to which Conditions FA3 and FA9 relate;

D. For the reasons set out Section 4 of the explanatory statement accompanying this Direction, in accordance with Section 49(2) of the Act, Ofcom is satisfied that this Direction is:

(a) objectively justifiable in relation to the networks, services, facilities, apparatus or directories to which it relates;

(b) not such as to discriminate unduly against particular persons or against a particular description of persons;

(c) proportionate to what it is intended to achieve; and

(d) in relation to what it is intended to achieve, transparent;

E. For the reasons set out in Section 4 of the explanatory statement accompanying this Direction, Ofcom is satisfied that it is acting in accordance with the relevant duties set out in Sections 3 and 4 of the Act in giving this Direction;

F. On 7 September 2005, Ofcom published a Notification of a proposal to give this Direction in accordance with section 49(4) of the Act and invited representations about the proposed Direction by 10 October 2005;

G. In accordance with Section 50 of the Act, a copy of the Notification was sent to the Secretary of State, the European Commission and the regulatory authorities of every other EU Member State;

H. Ofcom has considered every representation about the proposed Direction duly made to it;

NOW, THEREFORE, PURSUANT TO CONDITIONS FA3.1 AND FA9.2, OFCOM HEREBY DIRECTS THAT:

1. The Dominant Provider shall not charge more than £81.69 for the annual rental charge for access to Metallic Path Facilities.

2. The obligation on the Dominant Provider by virtue of Condition FA3.1 to secure, and to be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition FA1 and/or Condition FA9 is 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, shall not apply in respect of the proposed charge ceiling set out in paragraph (1) above.

3. For the purposes of interpreting this Direction, the following definitions shall apply:

“**Act**” means the Communications Act 2003;

“**BT**” means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 736 of the Companies Act 1985, as amended by the Companies Act 1989;

“**Dominant Provider**” means BT;

“**Metallic Path Facilities**” means a circuit comprising a pair of twisted metal wires from an end user premises to a main distribution frame that employs electric, magnetic, electro-magnetic, electro-chemical or electro-mechanical energy to convey Signals when connected to an Electronic Communications Network; and

“**Ofcom**” means the Office of Communications;

4. Except where otherwise defined or in so far as the context otherwise requires, any word or expression shall have the same meaning as it has in the Act.

5. The Interpretation Act 1978 shall apply as if this Direction were an Act of Parliament.

6. Headings and titles shall be disregarded.

7. This Direction shall take effect on 1 January 2006.

Andrew Heaney
Director of Competition Policy

A person authorised under paragraph 18 of the Schedule to the Office of Communications Act 2002

30 November 2005

Annex 2

Notification: amendment to SMP conditions FA6 and FB6

NOTIFICATION UNDER SECTIONS 48(1) AND 86(4) OF THE COMMUNICATIONS ACT 2003

Modification of SMP services conditions FA6 and FB6 as set out in Schedules 1 and 2 respectively to the Notification at Annex 1 to the wholesale local access market review statement published on 16 December 2004

WHEREAS:

A. OFCOM issued a notification on 7 September 2005 (the "First Notification") in accordance with sections 48(1) and 86(4) of the Act setting out its proposals for the modification of SMP services conditions FA6 and FB6, imposed on BT and Kingston respectively.

B. A copy of the First Notification was sent to the Secretary of State in accordance with section 50(1)(a), the European Commission and to the regulatory authorities of every other Member State in accordance with section 50(3) of the Act.

C. In the First Notification and accompanying explanatory statement, OFCOM invited representations about any of the proposals set out therein by 10 October 2005.

D. By virtue of section 48(5) of the Act, OFCOM may give effect to any proposals to modify or set SMP services conditions with or without modification, where:

> (a) it has considered every representation about the proposals made to it within the period specified; and
>
> (b) it has had regard to every international obligation of the United Kingdom (if any) which has been notified to OFCOM for this purpose by the Secretary of State.

E. OFCOM has considered the representations received in respect of the proposals set out in the First Notification and the accompanying explanatory statement; and the Secretary of State has not notified OFCOM of any international obligation of the United Kingdom for this purpose.

NOW THEREFORE:

1. OFCOM, in accordance with sections 48(1) and 86(4) of the Act, hereby makes modifications to SMP services conditions, by reference to market power determinations made in relation to markets in which OFCOM is satisfied there has been no material change since those determinations were made.

2. The modifications are further to the market power determinations made in the Notification under sections 48(1) and 79(4) of the Act by OFCOM on 16 December 2004 whereby BT was determined to have significant market power in the market for wholesale local access services

within the United Kingdom, but not including the Hull Area, and Kingston was determined to have significant market power in the market for wholesale local access services within the Hull Area.

3. As a result of, amongst other things, the market power determinations referred to in paragraph 2 above, BT and Kingston have been subjected to a number of SMP services conditions, including SMP services condition FA6, in respect of BT, and SMP services condition FB6, in respect of Kingston. OFCOM is modifying SMP services conditions FA6 and FB6 as set out in Schedules 1 and 2 respectively to this Notification.

4. The effect of, and OFCOM's reasons for making, the modifications referred to in paragraph 3 above are set out at Section 5 of the accompanying explanatory statement.

5. OFCOM considers that the modifications referred to in paragraph 3 above comply with the requirements of sections 45 to 50 and sections 78 to 92 of the Act, as appropriate.

6. In making the modifications set out in this Notification, OFCOM has considered and acted in accordance with its general duties in section 3 of the Act and the six Community requirements in section 4 of the Act.

8. Copies of this Notification and the accompanying explanatory statement have been sent to the Secretary of State in accordance with section 50(1)(a) of the Act, and to the European Commission and the regulatory authorities of every other Member State in accordance with section 50(2) of the Act.

9. In this Notification (not including the Schedules) -

(a) "**Act**" means the Communications Act 2003 (c.21);

(b) "**BT**" means British Telecommunications plc, whose registered company number is 1800000, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 736 of the Companies Act 1985, as amended by the Companies Act 1989;

(c) "**Hull Area**" means the area defined as the 'Licensed Area' in the licence granted on 30 November 1987 by the Secretary of State under section 7 of the Telecommunications Act 1984 to Kingston upon Hull City Council and Kingston Communications (Hull) plc;

(d) "**Kingston**" means Kingston Communications (Hull) plc, whose registered company number is 2150618, and any of its subsidiaries or holding companies, or any subsidiary of such holding companies, all as defined by section 736 of the Companies Act 1985, as amended by the Companies Act 1989;

(e) "**OFCOM**" means the Office of Communications; and

(f) "**United Kingdom**" has the meaning given to it in the Interpretation Act 1978 (c.30).

Andrew Heaney
Director of Competition Policy
A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002
30 November 2005

SCHEDULE 1

Proposed modification to SMP services condition FA6 imposed on BT as a result of the market power determination made by OFCOM on 16 December 2004 that BT has significant market power in the market for wholesale local access services within the United Kingdom, but not including the Hull Area

The following sentence shall be inserted at the end of SMP services condition FA6.1:

"*This obligation for prior notification will also not apply in relation to new or amended technical specifications determined by the Network Interoperability Consultative Committee*"

SCHEDULE 2

Proposed modification to SMP services condition FB6 imposed on Kingston as a result of the market power determination made by OFCOM on 16 December 2004 that Kingston has significant market power in the market for wholesale local access services within the Hull Area

The following sentence shall be inserted at the end of SMP services condition FB6.1:

"*This obligation for prior notification will also not apply in relation to new or amended technical specifications determined by the Network Interoperability Consultative Committee*"

Annex 3

SMP condition: requirement to notify technical information

Condition FX6

Requirement to notify technical information

FX6.1 Save where Ofcom consents otherwise, where the Dominant Provider:

(a) proposes to provide Network Access covered by Condition FX1 [and/or Condition FX9], the terms and conditions for which comprise new:

(i) technical characteristics (including information on network configuration where necessary to make effective use of the Network Access);

(ii) locations of the points of Network Access; or

(iii) technical standards (including any usage restrictions and other security issues), or

(b) proposes to amend an existing Access Contract covered by Condition FX1 [and/or Condition FX9] by modifying the terms and conditions listed in paragraph FX6.1(a)(i) to (iii) on which the Network Access is provided,

the Dominant Provider shall publish a written notice (the "Notice") of the new or amended terms and conditions within a reasonable time period, but not less than 90 days before either the Dominant Provider enters into an Access Contract to provide the new Network Access or the amended terms and conditions of the existing Access Contract come into effect. This obligation for prior notification will not apply where the new or amended charges or terms and conditions are directed or determined by Ofcom or are required by a notification or enforcement notification issued by Ofcom under sections 94 or 95 of the Act.

FX6.2 The Dominant Provider shall ensure that the Notice includes:

(a) a description of the Network Access in question;

(b) a reference to the location in the Dominant Provider's Reference Offer of the relevant terms and conditions; and

(c) the date on which or the period for which the Dominant Provider may enter into an Access Contract to provide the new Network Access or any amendments to the relevant terms and conditions will take effect (the "effective date").

FX6.3 The Dominant Provider shall not enter into an Access Contract containing the terms and conditions identified in the Notice or apply any new relevant terms and conditions identified in the Notice before the effective date.

FX6.4 Publication referred to in paragraph FX6.1 shall be effected by:

(a) placing a copy of the Notice on any relevant website operated or controlled by the Dominant Provider;

(b) sending a copy of the Notice to Ofcom; and

(c) sending a copy of the Notice to any person at that person's written request, and where the Notice identifies a modification to existing relevant terms and conditions, to every person with which the Dominant Provider has entered into an Access Contract covered by Condition FX1 [and/or Condition FX9]. The provision of such a copy of Notice may be subject to a reasonable charge.

Annex 4

The wholesale local access market – no material change

A4.1 Ofcom is empowered under section 86 of the 2003 Act to modify existing SMP services conditions without carrying out a market review. To do so, Ofcom must be satisfied that there has been no material change in the relevant markets since the conditions were set or the SMP determinations were made in December 2004. This annex sets out Ofcom's consideration of whether there has been a material change in any of the relevant markets.

Market definition

A4.2 Ofcom has reviewed whether the current market definitions still hold and could be expected to remain relevant for the remainder of the market review. Ofcom's definitions of the wholesale local access markets were included in the December statement. The market definition includes two parts: the product market definition and the geographic market definition. Product market definition is logically prior to geographic market definition.

Wholesale product market

A4.3 The December statement set out that the relevant wholesale local loop market included the provision of local access over twisted copper pairs as well as Siamese cable access. The December statement also set out that there are a number of potential candidate substitutes for wholesale local access and identified separate markets for:

- fibre;
- fixed wireless; and
- mobile.

A4.4 Ofcom's conclusion that cable-based and loop-based access services are effective substitutes, and as such are in the same relevant market, was based on substitution between cable-based and loop-based retail products undermining the profitability of a price increase at the wholesale level (indirect substitution). There is nothing that has occurred over the last 11 months since December 2004 that would lead Ofcom to conclude otherwise. In any case, even if it was appropriate to define a narrow wholesale market for loop-based local access only (excluding cable-based access) this could only affect the SMP conclusions if BT was found not to hold a position of SMP in the broader market. Similar reasoning applies to Kingston within the Hull Area.

A4.5 For fibre-based access services, there have been insufficient changes in the costs and roll out of fibre infrastructure for it to constrain the pricing of loop-based and cable-based local access such that it would lead Ofcom to conclude a broader market definition than at the time of the December statement.

A4.6 For fixed wireless access, there have not been any significant changes in the roll out or take up in the last 11 months for this access service to be regarded as an effective substitute for loop-based or cable-based local access.

A4.7 Mobile access was assessed not to be a sufficient substitute for it to be in the same market as fixed access primarily because mobile access was viewed to be an adjunct to fixed access. Because of the prevailing price differentials, it was unlikely that there would be effective demand side substitution in response to a price increase by a hypothetical monopolist in the provision of fixed access. There is no evidence to suggest that this has altered in the last 11 months.

A4.8 Ofcom remains of the view that it is appropriate to define a single wholesale local access market for supply to both residential and business customers. In particular, Ofcom does not believe that the choice between a single and separate residential and business markets would affect the overall conclusions of its SMP findings.

A4.9 In summary, Ofcom considers that its definition of a wholesale product market for loop-based and cable-based local access, as defined in the December statement, remains appropriate.

Wholesale geographic market

A4.10 Having considered the relevant product market it is necessary to consider the relevant geographic market. As with the definition of the product market, the geographic boundaries of the relevant market are defined by identifying all relevant competitive constraints.

A4.11 The December statement sets out that since the provision of a local loop or cable connection to particular premises is an inherently local activity, there is little scope for direct demand-side substitution to loops offered elsewhere. By definition, a customer can only purchase a relevant loop or cable connection from a supplier who can provide a connection to that end user’s premises. It follows too that the practical scope for supply-side substitution is likely to be limited to suppliers who have made infrastructure investments in the vicinity of the end user’s premises.

A4.12 Some overlap in the ‘catchment’ areas that can be served by the infrastructure at a given location may arise, with substitution then hypothetically possible for at least those consumers in the overlap between catchments. Where multiple overlaps of catchments arise in this way, chains of substitution may result in a single geographic market encompassing areas which are broader than indicated by direct substitution possibilities alone. Nevertheless, Ofcom concluded that this mechanism would be unlikely to result in an extensive broadening of the relevant market.

A4.13 However, Ofcom stated that this narrow approach to market definition could fail to capture adequately the competitive constraints operating on supply in a particular geographic area. Specifically, this approach takes no account of the geographic pricing constraints faced by specific firms in reality.

A4.14 Where firms choose, in practice, to adopt uniform pricing across local areas, local competitive pressures will have an impact only to the extent that they affect that single uniform price. Moreover, to the extent that local factors do influence that price, the effect will be transmitted beyond the particular area where the competitive pressure originally arose.

A4.15 For some wholesale services, BT’s charges are set by regulation at a level which does not vary with geography. In such cases, it cannot be automatically assumed that uniform pricing would continue in the absence of that regulation. Nevertheless, for other wholesale products, BT chooses to set uniform prices across its service area, even though it is not currently required to do so by regulation.

A4.16 On this basis there appear to be grounds for believing that BT would implement geographically uniform prices for local access even in the absence of regulatory constraints. It is also relevant that a number of BT's and Kingston's retail tariffs are required to be set on a nationally uniform basis across their service areas as a result of their universal service obligations. It is significant, too, that even the cable operators, who are not themselves subject to regulatory constraints, have adopted uniform retail pricing throughout their service territories.

A4.17 Since BT does not operate a local access network in the Hull Area, the impact of its uniform pricing policy will not extend across to that area. Similarly, Kingston's uniform pricing constraint will not materially affect locations outside the Hull Area.

A4.18 Ofcom's conclusion in the December statement was that there are two distinct wholesale geographic markets relevant for the purposes of this review, namely:

- the UK excluding the Hull Area; and
- the Hull Area.

A4.19 Nevertheless, Ofcom recognised that the broad UK geographic market is characterised, to some extent, by local characteristics including some variation in the degrees of competitive pressure.

A4.20 Since the December statement, BT has introduced geographically localised IPStream and DataStream charges, in the form of a discount off nationally average charges, in areas served by 561 local exchanges. These discounts reflect in part the fact that alternative operators will be able to compete with BT using LLU inputs from BT in these downstream markets. This may indicate that there are more local geographic markets in the provision of these downstream products. However, Ofcom does not consider that this development undermines Ofcom's conclusion that the local access market is national. This is because Ofcom's understanding is that BT's geographically localised IPStream and DataStream charges are as a result of variations in competitive pressures resulting from alternative operators using wholesale local access products (i.e. LLU) rather than a change in competitive pressures in the provision of wholesale local access products. There have been no other developments in the last 8 months that suggest to Ofcom that the relevant geographic market is no longer national.

Market power assessment

A4.21 The local access network remains one of the least competitive segments of communications networks overall. BT's market share of the wholesale local access market in the UK excluding the Hull Area remains around 82%.

Table A4.1

Local access connection volume shares for the UK excluding the Hull Area

	All Operators	BT	Ntl & Telewest	Other Direct Access	Other Indirect Access	BT share
2004 Q1	34,121	28,191	4,689	1,242	-	82.6%
2004 Q2	34,322	28,192	4,884	1,246	-	82.1%
2004 Q3	33,957	27,962	4,751	1,244	-	82.3%
2004 Q4	33,699	27,721	4,728	1,251	-	82.3%
2005 Q1	33,501	27,502	4,746	1,253	-	82.1%

Source: Ofcom estimates from operator data

A4.22 Kingston continues to supply around 100% of the relevant local access connections within the Hull Area.

A4.23 As set out in the December statement a change in the competitive conditions would require:

- a radical increase in the competitive appeal of the services provided by the cable operators;
- the emergence of a credible new entrant in the supply of wholesale local access services; or
- a transformation in the buyer side of the market.

A4.24 These scenarios have not occurred over the last 8 months and therefore Ofcom does not consider that the findings of SMP in respect of BT or Kingston have changed.

Conclusion

A4.25 Ofcom concludes that there has been no material change in the following markets:

- wholesale local access in the UK excluding the Hull Area; and
- wholesale local access in the Hull Area.

Annex 5

Glossary

This glossary is without prejudice to the definitions used Annexes 1 and 2.

Broadband: a service or connection which is capable of supporting always-on services which provide the end-user with high data transfer speeds.

BT: British Telecommunications plc.

DSL (**Digital Subscriber Line):** a family of technologies generically referred to as DSL, or xDSL, capable of transforming ordinary local loops into high-speed digital lines, capable of supporting advanced services such as fast Internet access and video-on-demand. ADSL (Asymmetric Digital Subscriber Line), HDSL (High bit rate Digital Subscriber Line) and VDSL (Very high data rate Digital Subscriber Line) are all variants of xDSL.

Hull Area: the area defined as the 'Licensed Area' in the licence granted on 30 November 1987 by the Secretary of State under section 7 of the Telecommunications Act 1984 to Kingston upon Hull City Council and Kingston Communications (Hull) plc.

Kingston: Kingston Communications (Hull) PLC, communications provider which operates in the Hull Area.

Local loop: the access network connection between the customer's premises and the local serving exchange, usually comprised of two copper wires twisted together.

Local loop unbundling (LLU): a process by which a dominant provider's local loops are physically disconnected from its network and connected to competing provider's networks. This enables operators other than the incumbent to use the local loop to provide services directly to customers.

Main distribution frame (MDF): the equipment where local loops terminate and cross connection to competing providers' equipment can be made by flexible jumpers.

Metallic Path Facilities: the provision of access to the copper wires from the customer premises to a BT MDF that covers the full available frequency range, including both narrowband and broadband channels, allowing a competing provider to provide the customer with both voice and/or data services over such copper wires.

Narrowband: a service or connection allowing only low data transfer speeds.

PSTN: Public Switched Telephone Network

Shared metallic path facility (SMPF)/shared access: the provision of access to the copper wires from the customer's premises to a BT MDF that allows a competing provider to provide the customer with broadband services, while the dominant provider continues to provide the customer with conventional narrowband communications.

SMP: The Significant Market Power test is set out in European Directives. It is used by National Regulatory Authorities (NRAs) such as Ofcom to identify those communications providers who must meet additional obligations under the relevant Directive.