Charge controls for Wholesale Line Rental and related services

Statement and consultation

Publication date: 26 October 2009

Closing Date for Responses: 7 December 2009

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Section 1

Summary

Introduction

1.1 In our statement on the *Review of Fixed Narrowband Services Wholesale Markets* (the Wholesale Review),[1] we determined that there is a single market for wholesale analogue exchange lines (outside the Hull area)[2] and that BT has significant market power (SMP) in that market. We also confirmed the continuing need for Wholesale Line Rental (WLR) as one of the key remedies addressing BT's SMP in that market. Furthermore, we explained our conclusion that, in the absence of regulation, Openreach has incentives to set prices for WLR higher than could be expected in a competitive market, and that a charge control is required to ensure that Communications Providers (CPs) are able to purchase WLR at the prices that would be expected in a competitive market.[3]

1.2 This statement sets out our decisions on the charge controls and therefore must be read in conjunction with the Wholesale Review.

1.3 In this document we also set out for further consultation our proposals on the implementation plan for the introduction of the new Core WLR Rental Service and our proposed approach to the regulation of higher care service options for WLR.

1.4 WLR is a product Openreach[4] supplies to Communication Providers (CPs), allowing them to rent access lines on wholesale terms, and resell the lines to customers. This product gives consumers the opportunity to choose alternative suppliers who can provide them with access and, in almost all cases, calls services. WLR has been and remains a central service supporting effective competition in fixed narrowband services at the retail level (as demonstrated by our recent finding that BT no longer held SMP in the provision of retail analogue access services).[5]

Background

1.5 The previous charge ceilings for WLR services were set in the 24 January 2006 statement, *Wholesale Line Rental: Reviewing and setting charge ceilings for WLR services* (the First WLR Statement).[6] Reflecting the separately defined markets for wholesale analogue exchange lines for residential and business customers in each of which BT was found to have SMP, Ofcom set two separate rental charge ceilings at that time.

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[1] http://www.ofcom.org.uk/consult/condocs/wnmr_statement_consultation/
[2] Rather than separate markets for business and residential wholesale analogue exchange lines defined by the Office of Telecommunications (Oftel) in 2003.
[3] http://www.ofcom.org.uk/consult/condocs/wnmr_statement_consultation/ see Section 16.
[4] Openreach is the access services division formed as a result of BT's Undertakings given to Ofcom in September 2005 in lieu of a reference to the Competition Commission under the Enterprise Act.
[5] Review of Fixed Narrowband Retail Services Markets http://www.ofcom.org.uk/consult/condocs/retail_markets/statement/
[6] http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/statement.pdf

Service	Current charge ceilings for annual rental
Residential WLR	£100.68
Business WLR	£110.00

1.6 These charge ceilings were fixed in nominal terms and have not changed since they were set in January 2006. Openreach has held the charges at the ceilings since they were set.

WLR Consultation

1.7 We published our consultation document '*Charge controls for Wholesale Line Rental and related services*'[7] (the WLR Consultation) on 3 July 2009. In the WLR Consultation we consulted on proposals for setting a new WLR charge control. We proposed moving from rental charge controls on both residential and business lines to a single control on a new core WLR rental service (based on a revised *WLR Basic* service) which will be available to residential and business customers.

1.8 In addition, the WLR Consultation sought stakeholder views on:

- the requirement for additional controls on options for higher care levels which can be purchased in combination with the Core Rental Service; and
- the proposed new charge ceilings for key installation and migration charges, that is the transfer of WLR lines between Communications Providers and the establishment of a new line.

1.9 We proposed that new controls would apply until March 2013, and we discussed the possible alternative of setting the control to end on March 2011 to ensure consistency of the LLU and WLR charge controls.

1.10 The WLR Consultation closed on 14 August. We received 10 responses, eight non-confidential[8] and two confidential. We have carefully considered each of the responses in making the decisions set out in this statement. We discuss the responses in detail in Sections 3 to 7.

Conclusions

1.11 In summary, we have decided that:

- The current controls on Residential and Business WLR will be replaced by a single control, for a Core WLR Rental service. The core WLR Rental Service will be available to all customers, residential and business, and will include a standard level of service and directory listings for residential and business numbers.

[7] Charge controls for WLR and related services, http://www.ofcom.org.uk/consult/condocs/wlrcc/
[8] Responses can be found at http://www.ofcom.org.uk/consult/condocs/wlrcc/responses/

- The implementation of the core WLR service will be phased in order to allow Openreach appropriate time to ensure that they can make necessary changes to their systems to be able to provide products that fulfil the requirements of the core service.

- We will set new price controls for some related services, WLR line transfers and new connections.

- The control will apply for the period to March 2011.

1.12 The new charge controls are set out below:

	Current price	Oct 09 –March 10	2010/11
New WLR Core Rental Service	£100.68	£100.68	RPI +3.8%
WLR transfer charge	£2.00	£3.00	RPI +3.8%
WLR new connection	£88.00	£67.00	RPI -16%

1.13 We are further consulting on three issues:

- The transition to the new WLR Core Rental service. We propose full introduction after the introduction of WLR3 functionality in Openreach's Release 1400, currently scheduled for July 2010.

- Operation of the *WLR Premium* charge ceiling for the period of the transition.

- The removal of the basis of charges (cost orientation) obligation on specific higher care services linked to WLR. We propose that Openreach may provide higher service levels at an additional charge. While such services will be subject to other SMP obligations imposed in the wholesale review (e.g. requirement not to unduly discriminate, requirement to publish a reference offer) we are proposing that they will not be subject to a basis of charges obligation.

Section 2

Framework for decisions and further consultation

Introduction

2.1 In this section we set out the background to the current WLR price controls, which were imposed as price ceilings. We also set out the context in which this review took place. In particular, we summarise:

- the conclusions of the Wholesale Review[9] which provides the authority and scope under which we can set the charge controls;
- the LLU Statement,[10] i.e. the recent statement on the pricing of copper access products and services, which established a cost analysis for such products, including WLR, which we have relied on in this review; and
- the legal framework in which we operate when considering and proposing charge controls as an SMP service condition.

WLR

2.2 WLR is a product Openreach supplies to CPs, allowing them to rent access lines on wholesale terms, and resell the lines to customers. This product gives customers the opportunity to choose alternative suppliers who can provide them with access and, in almost all cases, calls service. It has been and remains a central service supporting effective competition in fixed narrowband services at the retail level (see our recent finding that BT no longer holds SMP in the provision of retail analogue access services).[11]

2.3 WLR services make up around 56% of Openreach's total revenues, with sales (internal to BT and external) of £2.96 billion expected in 2009/10. WLR Rental represents the greater part of this revenue with sales totalling £1.63 billion and £0.579 billion respectively for *WLR Basic* and *WLR Premium*.

2.4 The returns on capital employed for *WLR Basic* and *WLR Premium* and WLR as a whole over the last three years are:

	07/08	08/09	*09/10**
WLR Basic	*13%*	*6%*	9%
WLR Premium	17%	12%	14%
WLR all services	16%	11%	12%

Source: LLU Statement

** Projected*

[9] http://www.ofcom.org.uk/consult/condocs/wnmr_statement_consultation/
[10] http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/
[11] Review of Fixed Narrowband Retail Services Markets http://www.ofcom.org.uk/consult/condocs/retail_markets/statement/

Regulatory background and context

2.5 In 2003 Oftel conducted a *Review of the fixed narrowband wholesale exchange line, call origination, conveyance and transit markets*[12] which found that BT had SMP in the exchange line markets. BT was required to provide WLR as a result of SMP service condition AA10. This continued the position under the previous regime when, from 2002, BT had been required to provide WLR as part of its licence conditions.

2.6 In addition to the requirement to provide WLR, the 2003 review also imposed charge controls on various services including the provision of WLR. The charge controls applied to WLR were set on an RPI-X basis to run from 1 September 2003 to 31 August 2006.

2.7 In September 2005, BT offered and Ofcom accepted a set of undertakings pursuant to section 154 of the Enterprise Act 2002. The Undertakings included the commitment to establish a new, functionally separate organisation, Openreach, in order to manage BT's wholesale access network. Openreach's remit therefore includes the provision of WLR.

2.8 In 2006 Ofcom published the First WLR Statement. It replaced the price controls set by Oftel with new fixed price ceilings for the provision of residential and business WLR services as follows:

Residential WLR	-	£100.68 pa
Business WLR	-	£110.00 pa

2.9 In 2008 we started a review of certain fixed charges for regulated network access services provided by Openreach, which we were concerned that since they were set on a static basis might have become out of balance with the efficiently incurred costs of providing those services (the Openreach Pricing Framework Review).

2008/9 Review of the Wholesale Fixed Narrowband Markets

2.10 In 2008 Ofcom undertook a review of the wholesale narrowband fixed markets, which included wholesale exchange line services and published the Wholesale Review on 15 September 2009.

Market definition and market power assessment

2.11 In the Wholesale Review, we concluded there was a single market for wholesale analogue exchange line services in the UK (excluding the Hull area). This market definition differs from the previous position of two separate markets defined by Oftel in 2003, namely:

- Wholesale residential analogue exchange line services; and
- Wholesale business analogue exchange line services.

2.12 We determined that BT had SMP in the market for wholesale analogue exchange lines with particular reference to BT's sustained high market share (around 81%) and

[12] http://www.ofcom.org.uk/static/archive/Oftel/publications/eu_directives/2003/fix_narrow0803_1.pdf

the existence of high barriers to entry. We further concluded that there was a risk of BT having the ability and the incentive to price excessively.[13]

SMP Remedies

2.13 In the Wholesale Review we also considered what remedies would be appropriate to impose in order to remedy the identified competition problems. The following SMP conditions were set on the wholesale analogue exchange lines market:

- Condition AAA1(a) – requirement to provide network access on fair and reasonable terms;
- Condition AAA1(b) – requests for new network access;
- Condition AAA2 – requirement not to unduly discriminate;
- Condition AAA3 – basis of charges;
- Condition AAA5 – requirement to publish a reference offer;
- Condition AAA6(a) – requirement to notify charges;
- Condition AAA6(b) – requirement to notify technical information;
- Condition AAA7 – transparency as to quality of service;
- Condition AAA10 – Requirement to provide Wholesale Line Rental etc.

2.14 We decided that BT should be required to provide a wholesale analogue WLR product. This remedy addresses BT's SMP by requiring it to provide a product that allows CPs to compete with BT's downstream businesses on an equivalent basis.

2.15 The Wholesale Review did not specify how the product should be provided, nor did it require that separate business and residential products should be maintained.

2.16 In addition to setting the above SMP conditions, the Wholesale Review found that there was a risk of excessive pricing of WLR by BT and therefore decided that there was a need for a charge control to be applied to the provision of the required analogue WLR product.

Basis for the analysis set out in this Statement

2.17 On 30 May 2008, we published an initial consultation document (the First Consultation), signalling our intention to review the fixed price ceilings previously set for local loop unbundling services, metal path facility (MPF) and shared metal path facility (SMPF), for WLR and in each case for connected ancillary services. We set out for comment our early views that those ceilings needed to be reviewed.

2.18 On 5 December 2008, we published a further consultation document (the Second Consultation), setting out in considerable detail the results of our review and our proposals for modifying the relevant charge controls. The charge controls for MPF, SMPF and connected ancillary services have since been revised by decision

[13] Paragraph 5.80 of the Wholesale Review.

contained in our statement of May 2009 (the LLU Statement). We ultimately decided to defer modifying the WLR price control pending the outcome of the Wholesale Review, which was proceeding in parallel.

2.19 In the Openreach Pricing Framework review, we undertook a lengthy and thorough detailed process of consultation and analysis. We conducted a detailed review of the underlying costs for the copper based services provided by Openreach. This included the development of a model of cost allocations between services and the determinations of key assumptions on future input cost trends, efficiency levels, appropriate cost of capital, cost allocations to Openreach from other parts of BT (e.g. BT Group) and cost allocations within Openreach to individual services.

2.20 We have used this analysis to determine in the LLU Statement the charges MPF and SMPF and related services. We also use that analysis to determine in this statement charge controls for WLR and connected ancillary services. We, therefore, rely for our decisions in this statement on the LLU Statement and accompanying annexes and the First and Second Consultations, as well as our WLR Consultation.[14]

2.21 LLU and WLR are alternative inputs in the provision of certain downstream services (ie combined provision of narrowband and broadband). Therefore, in setting the charge control for WLR it is relevant to consider the pricing relationship between WLR, MPF and SMPF. In particular, variations in the relative prices will impact on the level of investment in each of the services. In particular, as set out in Annex 4 of the LLU Statement, there are important efficiency reasons why the differential between (a) the sum of the WLR and SMPF charges and (b) the MPF charge should reflect the difference in the long run incremental cost of providing the two sets of services. Accordingly, it is important to set WLR consistently with LLU charges to avoid competitive distortions.

2.22 For the reasons set out below, we are confident that we have set the WLR charges on a consistent basis with the LLU charges and that the price differentials between the charges support an efficient allocation of resources.

2.23 This document now sets the charge control on the basis of all the relevant evidence and analysis and in light of the responses to the WLR Consultation and in accordance with our statutory duties and the relevant tests.

Legal Framework

2.24 Price controls are a specific remedy that Ofcom can impose under the harmonised framework for the regulation of electronic communications across the European Community (known as the Common Regulatory Framework, the"CRF"). The CRF comprises (amongst others) the Framework Directive[15] and four other directives referred to in the Framework Directive as the Specific Directives. The most relevant

[14] CPW Group plc (the parent company for TTG) has appealed the LLU Statement. We are confident that our assessments when setting the LLU price controls in that Statement were and remain appropriate and reasonable exercise of our regulatory judgement. In so far as, TTTG has advanced various of its arguments in that appeal in parallel by way of response to the WLR Consultation, we have taken full account of its response to the WLR Consultation in this statement.

[15] Directive 2002/21/EC of the European Parliament and of the Council of 7 March 2002 on a common regulatory framework for electronic communications networks and services.

Specific Directive as regards decisions made in this Statement is the Access Directive[16], particularly its Articles 8 and 13 (on price controls).

2.25 The requirements of the CRF were mainly implemented in the United Kingdom by the Communications Act 2003 (the “Act”), especially its Part 2 transposes the CRF to a significant proportion. Section 45 of the Act gives Ofcom the power to set two categories of conditions – general conditions and specific conditions, the latter comprising (amongst others) SMP services conditions. According to section 45(8), such conditions may only contain provisions that are authorised or required by one or more of sections 87 to 92. Section 45(10) provides that the power to set conditions includes (amongst others):

- the power to impose a requirement on the person to whom the condition is applied to comply with such directions with respect to the matters to which the condition relates as may be given from time to time by Ofcom; and

- the power to revoke or modify the conditions for the time being in force.

2.26 Conditions imposed pursuant to section 45, including SMP services conditions, can only be applied in accordance with section 46. In respect of SMP conditions, section 46 provides that the particular person to whom an SMP services condition is applied must be a communications provider whom Ofcom has determined to be a person having significant market power (“SMP”) in a specific market for electronic communications networks, electronic communications services or associated facilities.

2.27 Section 87 of the Act then provides that, where Ofcom has made a determination that a person has SMP, it shall set such SMP conditions authorised by that section as it considers it appropriate to apply to that person. Section 87 goes on to list the subject-matter of the SMP conditions that Ofcom can impose, which list corresponds to the specific obligations identified in Articles 9 to 13 of the Access Directive, including price controls as authorised SMP conditions by section 87(9).

2.28 This Statement imposes charge controls on BT by means of setting a new SMP condition—Condition AAA4(WLR)—using Ofcom’s powers under section 45 of the Act. Ofcom has set that condition in accordance with the process prescribed by section 48 of the Act under a notification published at Part I of Annex 6 to this Statement. The products and services affected by those charge controls are discussed in more detail in Sections 3 and 6 of this Statement. Separately, but linked to Ofcom’s decision to impose the charge controls, we have also decided to make the proposed modification to SMP condition AAA3 to make it clear that, except for charge for analogue core WLR rental, services charge controlled under SMP service condition AAA4(WLR) remain subject to the basis of charges requirement in the former condition, for the reasons set out in the WLR Consultation: see in particular paragraphs 7.71ff. The legal instrument giving effect to that modification is also published at Part I of Annex 6 to this Statement.

2.29 As explained in Section 1, we are further consulting on some additional issues, which proposals involve setting a new SMP condition—Condition AAA4(B)—again using Ofcom’s powers under section 45 of the Act to maintain the charge ceiling for the annual rental of a Wholesale Analogue Line Rental (business quality of service),

[16] Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 on access to, and interconnection of, electronic communications networks and associated facilities.

which service was subject to the charge ceiling imposed by means of a direction given by Ofcom in the First First WLR Statement. The history of the charge ceilings are discussed earlier in this Section. The legal instrument for that proposal is at Part II of Annex 6 to this Statement. Our proposals also involve giving new directions following the process prescribed by section 49 of the Act and the associated legal instruments are published at Parts III to IV of Annex 6 to this Statement.

2.30 The decisions and proposals referred to above address Ofcom's findings made in the Wholesale Review with respect to Ofcom's determination that the relevant market for wholesale analogue exchange line services is not effectively competitive as BT is a communications provider having SMP in that services market. They are also based on the nature of the problems identified from that market analysis. In light of this, we summarise below Ofcom's statutory duties and legal tests relevant to the decisions and further proposals discussed in the remainder of this Statement. We set out in Section 8 of this Statement how they are secured and met in setting out our conclusions.

Sections 47 and 49

2.31 Section 47 of the Act requires that any condition set must be:

i) objectively justifiable;

ii) not such as to unduly discriminate;

iii) proportionate;

iv) transparent.

2.32 Section 47 was considered in the Wholesale Review, including as to whether a charge control is an appropriate remedy to address the competition problems identified in Ofcom's market analysis. This review has concentrated on the design and mechanics of the charge control, and, in setting the related SMP condition, applies the tests set out in section 47. We have also applied those tests to the modification to SMP condition AAA3 and the proposed new SMP condition AAA4(B) imposing the charge ceiling for a transitional period.

2.33 Like section 47, section 49 of the Act requires that any direction given or direction withdrawn must be:

v) objectively justifiable;

vi) not such as to unduly discriminate;

vii) proportionate;

viii) transparent.

2.34 We have therefore applied those tests to the proposed directions.

Section 88

2.35 Before Ofcom imposes a price control under an SMP condition authorised by section 87(9) of the Act, we must ensure that the setting of such condition complies with section 88 of the Act.

2.36 Section 88(1) requires that such conditions must only be set where it appears to Ofcom from the market analysis that there is a relevant risk of adverse effects arising from price distortion, such as if the dominant provider might fix or maintain some or all of his prices at an excessively high level.

2.37 Furthermore, it must also appear to Ofcom that the setting of the condition is appropriate for the purposes of:

(i) promoting efficiency;

(ii) promoting sustainable competition; and

(iii) conferring the greatest possible benefits on end users.

2.38 In addition, under section 88(2), we must take account of the extent of the investment made by the dominant provider.

Section 3 – Ofcom's general duties

2.39 Under the Act, our principal duty in carrying out functions is to further the interests of citizens in relation to communications matters and to further the interests of consumers in relevant markets, where appropriate by promoting competition.

2.40 In so doing, we are required to secure a number of specific objectives and to have regard to a number of matters, as set out in section 3 of the Act. As to the prescribed specific statutory objectives in section 3(2), we consider that the objective of securing the availability throughout the UK of a wide range of electronic communications services objectives as particularly relevant to this Statement.

2.41 In performing our duties, we are also required to have regard to a range of other considerations, as appear to us to be relevant in the circumstances. In this context, we consider that a number of such considerations are relevant, namely:

- the desirability of promoting competition in relevant markets;
- the desirability of encouraging investment and innovation in relevant markets; and
- the desirability of encouraging the availability and use of high speed data transfer services throughout the United Kingdom.

2.42 We must also have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent, and targeted only at cases in which action is needed, as well as the interest of consumers in respect of choice, price, quality of service and value for money.

2.43 Ofcom has, however, a wide measure of discretion in balancing its statutory duties and objectives. In so doing, we have taken account of all relevant considerations, including responses received during this consultation process, in reaching our conclusions and further proposals set out in this Statement.

Section 4 – European Community requirements for regulation

2.44 As noted above, our decisions and further proposals involve Ofcom exercising functions falling under the CRF. As such, section 4 of the Act requires us to act in accordance with the six European Community requirements for regulation.

2.45 In summary, these six requirements are:

- to promote competition in the provision of electronic communications networks and services, associated facilities and the supply of directories;
- to contribute to the development of the European internal market;
- to promote the interests of all persons who are citizens of the European Union;
- to take account of the desirability of Ofcom's carrying out of its functions in a manner which, so far as practicable, does not favour one form of or means of providing electronic communications networks, services or associated facilities over another, i.e. to be technologically neutral;
- to encourage, to such extent as Ofcom considers appropriate for certain prescribed purposes, the provision of network access and service interoperability, namely securing efficient and sustainable competition and the maximum benefit for customers of communications providers;
- to encourage compliance with certain standards in order to facilitate service interoperability and secure freedom of choice for the customers of communications providers.

2.46 We consider that the first and fifth of those requirements are of particular relevance to this Statement and that no conflict arises in this regard with those specific objectives in section 3 that we consider are particularly relevant in this context.

Impact assessments

2.47 The analysis presented in the rest of the Sections and Annexes of this Statement represents an impact assessment, as defined in section 7 of the Act.

2.48 Specifically, pursuant to section 7, an impact assessment must set out how, in our opinion, the performance of our general duties (within the meaning of section 3 of the Act) is secured or furthered by or in relation to what we propose.

2.49 The decision in the Wholesale Review that a charge control was appropriate for analogue WLR services was subject to an impact assessment set out in that review. The decisions and proposals made in this Statement relate to how a control should be implemented. They therefore also concern an important proposal, since they have a significant impact on Openreach and other CPs who purchase its WLR product and, as a result, we have undertaken a further impact assessment as part of this specific review. The discussion of the options available to us in deciding on our approach to a charge control, how they meet our statutory obligations and how they impact on competition and stakeholders, is an integral part of this review as a whole. Accordingly, we consider that this Statement in its entirety constitutes the impact assessment, noting in particular that Sections 3 and 4 deal with the assessment of options.

2.50 We have also considered the requirement for a detailed Equality Impact Assessment (EIA). Our analysis of the impact of the proposals did not indicate any specific equality issues arising from the matters covered in this review.

Consultation Period

2.51 In this document Ofcom also consults on various additional proposals. It invites written views and comments on the issues raised in this document, to be made **by 5pm** on **7 December 2009**. In deciding that a six week period for consulting on our additional proposals is appropriate, we have taken into account that the wider issues relating to these proposals have already been the subject of the WLR Consultation and therefore are familiar to stakeholders. Also, our two proposed directions and proposed withdrawal of a previous direction involve only limited amendments to regulation imposed in this Statement. Whilst our Consultation Guidelines of November 2007 state that a one month consultation should be allowed in these circumstances, we have allowed some additional time to ensure that stakeholders have enough time to respond.

Section 3

WLR Core rental service

Introduction

3.1 In this section we re-cap on the options for setting new charge controls on WLR rentals set out in the WLR Consultation and set out the responses of stakeholders to those proposals and our final decision. We also consider issues associated with the implementation of this new control and consult on a revised implementation plan.

3.2 In summary, we have concluded that we will:

- set a single charge control for the core rental element of WLR services covering all wholesale analogue exchange lines rather than setting separate charge controls for residential and business lines;
- require Openreach to offer the charge controlled service to all customers, allowing it to be able to offer it in combination with enhanced service elements to create premium and value-added services; and
- set the control to end on 31 March 2011.

3.3 As a minimum the new core service will provide:

- analogue line rental;
- a basic level of service support; and
- a Residential or Business (as appropriate) directory listing.

3.4 We have accepted that such a change to the regulatory regime will require a transitional period to allow stakeholders including Openreach time to adapt to the new requirements. It will therefore be introduced on a phased basis as follows:

- The first phase (starting from 28 days after this statement – i.e. 23 November 2009) will see the introduction of the new SMP condition AAA4 (WLR) which relates to the new WLR Core Rental service. This will be available to all CPs, but Openreach will not be required to offer a business directory listing. Since an acceptable substitute product is not available during this transitional phase, we will maintain the 2006 charge ceiling[17] in force for WLR (business quality of service) as a safeguard cap.
- The second phase will extend the obligation to require Openreach to offer business listings as part of the core service.
- We are consulting on a new condition to set the WLR business ceiling at its current level (i.e. £110 p/a) with a sunset clause which will dis-apply the condition when the new WLR Core Rental with the option of business directory listing is available – i.e. at the start of the second phase. We are also consulting on whether this timing for the ending of the ceiling requirement is appropriate or

[17] http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/

whether the ceiling should continue to apply through to the end of the charge controls (i.e. 31 March 2011).

3.5 Openreach currently offers two separate WLR services: *WLR Basic* and *WLR Premium*. There are three differences between the *WLR Basic* and *WLR Premium* products:

- *WLR Premium* has greater care level commitments than *WLR Basic*;
- *WLR Basic* only offers a Residential directory listing; *WLR Premium* offers a choice of either a Residential or Business listing ; and
- *WLR Basic* can be connected to network terminating equipment (NTE); *WLR Premium* can be connected to NTE or a network test and termination point (NTTP).[18]

3.6 Of these, we believe that the only factor giving rise to a substantive cost difference is the difference in care levels. As can be seen from the table below, each of the WLR products has three levels of care.[19] For both *WLR Basic* and *WLR Premium*, there is no incremental charge for Level 1 care, i.e. it is bundled with line rental. However, the commitments in *WLR Basic* Level 1 are lower than those in *WLR Premium* Level 1. Levels 2 and 3 provide enhanced levels of care and involve a charge in addition to line rental.

		Level 1	**Level 2**	**Level 3**
WLR Basic	Repair time	96 hours (Monday to Friday)	72 hours (Monday to Saturday)	24 hours
	Charge	Inclusive	£3.39 / quarter	£9.30 / quarter
WLR Premium	Repair time	48 hours (Monday to Friday)	48 hours (Monday to Saturday)	24 hours
	Charge	Inclusive	£3.39 / quarter	£9.30 / quarter

3.7 Openreach argues that there is some small additional cost in the provision of a business directory listing (under £1). We have found no evidence that the difference between NTE and NTTP affects the on-going costs of providing the services. However, there are substantial one-off system integration costs in making NTTP available as part of a core service (this is discussed in detail later in this section).

3.8 In addition to the two services – i.e. *WLR Basic* and *WLR Premium*, Openreach currently provides two generations of WLR services – WLR2 and WLR3. WLR2 was

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[18] An NTTP installation allows a business to more simply link multiple internal lines to a single (or multiple) external lines.
[19] See http://www.openreach.co.uk/orpg/pricing/loadProductPriceDetails.do?data=PhBKFq4UU57z6GBPt8DIoSUycYeyp0LS%2FM7XrdsmaHfgP3UPszSry78iVKC0gUAr

launched in April 2004 and is used only by CPs other than BT. WLR3 comprises the latest generation WLR services. It was launched in January 2007 and is continuing to be developed. Currently, some CPs use WLR2 and some use WLR3. By March 2011, all CPs will have had to migrate to WLR3 as WLR2 will be withdrawn on 30 June 2011.

The Service Harmonisation initiative

3.9 A key related development in considering the appropriate regulatory framework for WLR services is the Service Harmonisation initiative currently being undertaken by Openreach in conjunction with the Office of the Telecoms Adjudicator (OTA) and interested CPs. Through the Service Harmonisation initiative, Openreach intends to rationalise its current set of eight distinct service levels for WLR and LLU and to provide harmonised care levels which can be used in conjunction with both LLU and WLR services.

3.10 The new approach will be more transparent and less confusing for CPs, consistent between LLU and WLR, and will offer ‘insurance options’ (i.e. guaranteed service levels for a regular payment or on-demand care) for both.

Current regulation of charges for WLR Basic and WLR Premium

3.11 *WLR Basic* and *WLR Premium* are currently subject to regulation to ensure that Openreach cannot charge excessive prices. The First WLR Statement set two separate ceilings:

- for the annual rental of a Wholesale Analogue Line Rental (residential quality of service), set at £100.68; and
- for the annual rental of a Wholesale Analogue Line Rental (business quality of service), set at £110.00.[20]

3.12 Openreach currently offers its *WLR Basic* product to provide line rental with a residential quality of service and *WLR Premium* to provide line rental with a business quality of service.

Options set out in the WLR Consultation for regulating WLR rental charges

Scope of the charge control

3.13 In the WLR Consultation we identified three main options for regulating WLR rental charges:

- Option 1 – separate charge controls for *WLR Basic* rentals and *WLR Premium* rentals (i.e. the current situation);
- Option 2 – a single charge control for a core WLR rental service; and
- Option 3 – a basket control containing both *WLR Basic* and *WLR Premium*.

[20] http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/

3.14 We assessed those options against our statutory duties and the relevant legal tests set out in the Act and, in doing so, we also had particular regard to the following matters:

- consistency with the market definitions proposed in the Wholesale Review;
- the desirability of Openreach having the incentive to develop and offer additional services, such as modified or new forms of care level;
- ensuring that Openreach does not have the ability to price discriminate to the detriment of consumers and competing CPs; and
- the most efficient recovery of costs through prices being set in a manner that provides the greatest benefit to consumers and citizens.

3.15 In summary we considered that the market definitions in the Wholesale Review make the imposition of two separate charge controls for *WLR Basic* and *WLR Premium* disproportionate to the competition concern. Therefore, we did not consider that remaining with the current approach, Option 1, is appropriate.

3.16 We considered Options 2 and 3 to be the most likely charge control structures for furthering consumers' interests. With both of these options, Openreach would have the ability and an incentive to offer enhanced care services. They would both also allow Openreach some flexibility over the nature of the enhanced care services, consistent with its Service Harmonisation initiative.

3.17 It is possible that by making price discrimination between business and residential customers easier, the basket approach (Option 3) might result in more efficient pricing – e.g. by pricing according to different demand elasticities between the services. However, it is far from clear that such an approach would be beneficial, and in fact flexibility of pricing between residential and business services could result in competitive distortion and/or detriment to consumers. Given these uncertainties, this approach was not our preferred option.

3.18 We therefore favoured the option of creating a control on the core rental element of WLR services. We considered this best meets the criteria to which we have had regard and also has the advantage of aligning the framework for WLR controls more closely with MPF – i.e. a single core service not differentiated by business or residential use. The service would need, as a minimum, to include the option of a residential or business directory listing. Openreach would be free to sell enhanced care products in addition to the core rental service, including any new enhanced care offerings. This arrangement should ensure that Openreach has an incentive to develop new enhanced care packages.

3.19 Further, Openreach could still market bundled products such as *WLR Premium*, if it so chooses. Under this option we would regard the core element of any such bundled package to be charge controlled, with any enhanced element (including enhanced levels of care), making up the difference in price between the cost of the Core service and the cost of the bundled product. In this framework, *WLR Premium* would therefore be regarded as £100.68 of core rental, which is subject to a charge control and £9.32 of enhanced features which is not subject to that control.

Duration of the charge control

3.20 In the WLR Consultation we proposed that the new WLR charge control should run from October 2009 to 31 March 2013.

3.21 Our view was that we considered this duration provides a good balance between different objectives. On the one hand, we want to provide incentives for Openreach to reduce its costs via efficiency gains. But, on the other hand, we want to pass those gains to customers and encourage efficiency by bringing prices into line with costs. The longer the duration of the control, the greater the risk of prices moving out of line with costs due to forecasting error.

3.22 We also suggested that the setting of a charge control with a 3.5 years duration, i.e. to March 2013, would also allow us to coordinate future LLU and WLR charge controls more easily as they would both then be set on a BT financial year basis.

3.23 We did note, however, that the most significant risk with the proposed approach is that if exogenous factors changed significantly between now and when an MPF charge is re-considered in April 2011 (for example, if there is a significant change in the price of copper), there could be a risk of inconsistency between the WLR and MPF charges.

Stakeholder responses

Support for a core WLR rental

3.24 Stakeholders were supportive of our proposal to regulate a single core rental service.

3.25 Openreach agreed with Ofcom's preferred option to set a control on a WLR Core Rental service that is available to CPs serving residential and business end-users. Openreach noted that 'it supports the focus of regulation on a WLR Core service, with greater freedoms for the pricing of WLR Premium and other value-added services'.

3.26 TTG agreed in principle that moving to a single Core Rental service is a reasonable approach.

3.27 C&W supported the proposal to set a charge control for a single Core Rental service.

3.28 Sky said that 'Sky supports Ofcom's proposal to set a control on WLR core rental services to be available both to residential and business customers. In our view it is simpler; it simplifies the complexity of cost allocation between business and residential services, and it frees Openreach to innovate around premium levels of care'.

3.29 Optimity supported the opportunity to move some of its business customers to a lower priced tariff, 'The "business tariff" premium is not appreciated by very small businesses/home offices for directors'.

Caution on higher care service control

3.30 Some stakeholders cautioned that this restructuring should be linked to the continued monitoring of Openreach's provision of higher service level. For example, C&W stated that 'We agree with Ofcom that the most significant difference between *WLR Basic* and *WLR Premium* is the service levels and options for directory entries. We

think it makes sense to reflect this by providing for a regulated basic core service and enabling Openreach to offer premium products based on a range of superior service levels and options for directory entry…. The proposal in this consultation therefore amounts to a relaxation of regulation. We would only regard this as a positive step in circumstances where the proposed core WLR service gives all of our business customers true flexibility to choose the level of care they require and providing that sufficient safeguards exist as to the price of the care levels'.

Scope of core service

3.31 There was some discussion with respect to the services that should be included within the new core rental service. Specifically a number of stakeholders questioned the appropriateness of excluding the NTTP feature.

3.32 C&W noted that the 'current *WLR Premium* product can be connected to NTE or a network telephony termination point (NTTP). Given that the core WLR service will now be used by business customers, it should include the ability to be connected to NTTP. It is necessary that current *WLR Premium* customers with existing NTTP can migrate to the core WLR product if they choose to'.

3.33 The FCS also argued that 'an NTE or NTTP termination type should be available on a line that is being considered as a basic business product. As noted in paragraph 3.9 of the WLR Consultation there is no cost differential between supplying the two different termination types, therefore we believe any core WLR rental service should have the option of either termination type'.

3.34 Openreach argued that the inclusion of NTTP was disproportionate. 'Openreach does not consider that a NTTP, which does not support broadband, is an appropriate element within a WLR Core service. Rather, the use of analogue lines to support a NTTP is a niche business service of relatively low volume. Should they be required as an element within the development of the WLR Core service, this would drive cost, complexity and potential delay to the development of the service and could also impose costs on CPs to consume – whether they finally elected to purchase the service or not'.

3.35 Additionally, Openreach also stated that the core service should be limited to the WLR3 platform. Openreach confirmed that *WLR Basic* and *WLR Premium* are currently available through three different platforms: BT Retail Classic (BTRC), WLR2 and WLR3. Openreach stated that WLR2 is scheduled to be withdrawn by June 2011 and therefore any development costs could be considered as inefficient.

Duration of the charge control

3.36 All respondents agreed with the need for consistency with the LLU controls. While some respondents accepted that a 3.5 year term was useful for planning purposes, they noted caution about the risk of inconsistency with LLU in the latter years of the controls e.g. C&W noted that:

'We understand that Ofcom's cost modelling starts from April 2009 to ensure consistency with LLU charges. In principle, we agree that a three and a half year charge control period from October 2009 is an appropriate period over which to predict changes in costs, volumes and efficiencies. However, we believe that this should be subject to the written proviso that, in the event that Ofcom declines to impose cost orientation or charge control other than on the core WLR service, it would be prepared to step in and impose new conditions on BT before the end of this

term if this were necessary in the interests of competition and/or to prevent abuse of SMP'.

3.37 Other stakeholders, including Openreach, Post Office, SSE and TTG, considered that the risk of inconsistency was too great if the WLR control period was allowed to run longer than that of LLU. SSE also highlighted the risk that the longer term would not take proper account of network changes in BT.

Need for a transitional period

3.38 In the WLR Consultation we did not discuss in detail specific implementation issues. However, we did ask the following question:

Question 3.3 Please provide your views on the requirement for and if necessary, duration of any transition period for the implementation of a core WLR service?

3.39 While Sky, SSE and Orange did not make any comments in relation to a transition period for implementation, Post Office, FCS, TTG and Virgin Media recognised that there would be changes for both Openreach and CPs which needed to be considered. Openreach also provided detail in its response as to the effect of implementing a single core product and a timeline which it believes is suitable, and that would not hinder the agreed WLR3 migration program. C&W did not have any particular requirements regarding a transition period, but did state 'It is important that all current *WLR Basic* and *WLR Premium* customers can migrate to the core service plus which ever care Level (1 or above) they choose at no cost'.

3.40 Virgin Media stated that in addition to changes that CPs would need to make to systems, processes and commercial offerings, it was not clear from the consultation the degree of impact the proposal would have on Openreach's systems and processes. However, Virgin Media suggested that a transition period of at least 90 days would be appropriate. Post Office raised a similar point noting that 'Any change to how Service Providers purchase WLR from Openreach is likely to have an impact on ordering and management systems…'. It envisages that it should take no longer than six months for its systems to be adapted through the wholesale company who manages its service. Post Office also indicated that CPs were 'in the process of planning migrations from WLR2 to WLR3 platforms' and that Ofcom should bear this in mind when considering a transition period.

3.41 TTG also proposed a similar transition period as Post Office, indicating that once changes had 'been implemented by Openreach and made available to CPs, it would take 3 – 6 months for these to be adopted by CPs'.

3.42 FCS stated that it seems 'the creation of a "core" WLR service will be achieved by the disaggregation of the service level from the line rental and an alignment of pricing between *WLR Basic* and *WLR Premium*, yet the assets would still be recorded in the same way in Openreach's systems'. It agrees that this approach provides greater flexibility for CPs and end users, but 'does not move us much closer to a truly core WLR service, where all assets are recorded the same way in Openreach's systems'. It believes that *WLR Basic* lines should be withdrawn from new supply at a certain point, 'as well as removing the cost of migrating from *WLR Basic* Single Line to a *WLR Premium* Single Line from the date the price controls come into effect'.

3.43 In its response, Openreach stated that 'The scope and implementation of the new WLR Core rental product needs to be delivered in a way that encourages efficient investment; acknowledges the existing development roadmaps agreed with CPs, and

provides the appropriate level of service from day one'. Openreach's initial assessment is that making the Business Directory Entry available to the basic product would constitute a 'medium sized' development in terms of complexity to deliver. Openreach suggests that specific timing for implementation would need to be agreed with industry and Ofcom. However, Openreach proposes that this be incorporated into Release 1400[21], which is currently scheduled for July 2010. Openreach indicated that principle elements of the prior release (R1300 for launch in March 2010) had already been agreed with OCPs and therefore to attempt to include the upgrade in this release would be likely to be disruptive to content and CPs.

3.44 Openreach also suggested that to cover the transition period between when the charge control comes into effect and when it is able to actually deliver the new core service, it could provide a 'voluntary commitment not to exceed the current ceiling for the WLR Premium rental service until such time as the WLR Core functionality has been delivered'.

Ofcom's conclusions

3.45 Taking account of the evidence, and given the support for the proposal for basing the rental charge control on a WLR Core Rental service, we have decided to implement the charge control on the core rental element of WLR.

3.46 This decision requires clarification of some further questions. These are discussed in the remainder of the section. They are:

- scope of the core service;
- duration of the controls; and
- transitional arrangements.

3.47 Ofcom's approach to service levels and features outside the core service is discussed in subsequent sections.

Scope of core service

3.48 As set out in the stakeholder comments above, the primary concern with respect to the scope of the WLR Core Rental service is the exclusion of the NTTP feature.

3.49 There is clearly some attraction to the inclusion of the NTTP feature in the core service. It is simply an alternative installation configuration and the on-going costs are the same as those for an NTE installation. However, the inclusion of NTTP would incur additional system integration costs – both direct costs to Openreach and opportunity costs to the WLR user community as any work on this feature's inclusion could push out other updates to the WLR3 system.

3.50 We sought further information from Openreach on the current numbers of lines with NTTP and its current projections about the number of lines likely to use this feature in the future.

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[21] Release 1400 is part of Openreach's continuing software release program of upgrades to its WLR3 product. Each Release contains a number of upgrades, as agreed with CPs.

3.51 Openreach has indicated that there are currently around 50,000 single line NTTP installations in *WLR2 Premium* out of an entire *WL2 Premium* estate in excess of 1.3 million lines. In the past two years, there has been a reduction of about 10% of the NTTP lines. This trend seems likely to continue over the medium term. In particular, the use of a NTTP on a line means that broadband or messaging services cannot be used over the line. The movement from traditional to IP switches is expected to result in a further decrease in NTTPs.

3.52 In addition to the total number of NTTP installations, a second question is the likely demand for NTTP as part of a basic core service rather than requiring a higher care level. NTTP installations tend to be in business premises with higher communication demands. It is therefore likely that a large proportion of such businesses may expect a higher level of care than that provided in the Core service. While this cannot be quantified, it would be reasonable to suggest that the overall level of real demand for NTTP as part of a core WLR service would be well below current NTTP line numbers.

3.53 Given the current level of demand for NTTP installation and the likely future requirements for this service, we recognise the risk that an immediate requirement for inclusion of NTTP in the core service would be disproportionate, both in terms of the cost impact on Openreach and any knock on impact in terms of other system development for WLR3. As such, it would be inefficient to require it. Therefore we have decided that we will not require the inclusion of the NTTP feature in the new Core Rental service.

3.54 We remain open in the future to a reconsideration of this position on NTTP if it is clear that the WLR user community is concerned about the availability of NTTP as part of the core service.

3.55 We also considered Openreach's suggestion that the core service should be limited to the WLR3 platform. In designing this control we do not seek to regulate individual product offerings from Openreach, but rather the service that they provide. However, we do recognise that it would not be appropriate to require investment in a product (WLR2) that is due to be withdrawn in 18 months time.

3.56 We therefore propose that when we extend the application of WLR Core to include a requirement to supply a business directory listing, this should only be in relation to WLR3 lines. As this change is to be made in conjunction with Openreach's Release 1400 upgrade, scheduled for July 2010, this would only leave 9 months (until March 2011) until customer migrations from WLR2 to WLR3 platform have been completed. We consider the effect of this below when proposing how to withdraw the 2006 WLR charge ceiling.

Duration of the charge controls

3.57 We have reviewed our proposal on duration for the charge control in response to the comments of stakeholders.

The WLR Consultation

3.58 In the WLR Consultation, we proposed that the WLR charge control should run to March 2013 and explained the benefits for dynamic efficiency which we considered would flow from setting a control of that duration. We explained the trade-off between dynamic efficiency and allocative efficiency in setting charge controls which is a key consideration in deciding duration.

3.59 Allocative efficiency is achieved when prices are set equal to costs. Dynamic efficiency is achieved when firms have efficient incentives to invest and innovate. One of the characteristics of price caps and charge controls generally is that they have strong incentives for dynamic efficiency achieved through the setting of an RPI+/- X indexation of prices which enables the regulated firm to earn returns above the cost of capital if it outperforms the controls. Other things being equal, longer controls strengthen this incentive by giving regulated firms a longer opportunity to realise efficiencies and hence boost profitability. Shorter controls therefore have weaker incentives for dynamic efficiency, but they often have outcomes which are closer to allocative efficiency as the controls are re-set to reconcile with costs at shorter intervals.

3.60 In the WLR Consultation we explained that Ofcom has favoured four year price caps and charge controls in other markets – for example, the Retail Price Controls and Network Charge Controls – on the basis that a four year duration struck an effective balance in the trade-off between dynamic and allocative efficiency. This has proved to be an effective method of regulation driving efficient pricing and investment, for example in narrowband calls markets. This experience was a factor in our proposal to set a charge control for WLR to run until March 2013 (a duration of 3.5 years).

3.61 However, we also identified a risk in setting a longer control of inconsistency in between the WLR and LLU charges.

Our considerations

3.62 As noted in paragraphs 3.38 – 3.39 above, the majority of stakeholders stressed the importance of consistency in the setting of charge controls for LLU (MPF and SMPF) and WLR. A number of stakeholders – including Openreach, C&W, Post Office, TTG and SSE – said there was a high risk of inconsistency between the LLU and WLR charge controls towards the end of a 3.5 year duration for WLR charge controls. In addition, TTG stated that *the only way* Ofcom could ensure consistency was to align the LLU and WLR charge controls so that they could be set consistently with one another over the same time frame.

3.63 We agree that consistency is important as LLU and WLR share a largely common cost base, and both services are inputs to common downstream markets. Therefore, inconsistencies could result in competitive distortions (we examine this issue in detail in Section 5).

3.64 We note the point made by a number of stakeholders a higher risk of inconsistency with a 3.5 year control. There are a number of ways in which we could deal with the risk of inconsistency, however, in this case we have decided that to provide greater regulatory certainty it is preferable to set a short charge controls expiring in March 2011. [22]

3.65 In reaching this conclusion, we have taken into account that the dynamic efficiency incentives, one of the key benefits of a longer control, in this case would be diluted by any need to review costs ahead of any new LLU charge control in 2011.

Conclusion

[22] We have the power to reset charge controls where there has been no material change since the market review was conducted or where it is appropriate to carry out a new market review.

3.66 For the reasons set out above we have decided to set the term of the control to finish on 31 March 2011.

Transition period and implementation

3.67 We have considered options for timing of introduction of the new WLR Core Rental service.

3.68 We agree with stakeholders that the scale and timing of implementation is important and that this needs to be considered in conjunction with the process for migration to WLR3. Based on the feedback we received to the consultation and on discussions held during and after the consultation closed, we are now re-consulting in this statement on our proposed approach to the timing of full implementation and the transitional arrangements.

3.69 We consider that the new WLR Core Rental service should be available as soon as possible. However, we are mindful that mandating a transition which is too quick would run the risk of creating inefficient costs, and accelerating the systems developments needed for creation of the WLR Core Rental service at the expense of other agreed developments. In considering the timing of implementation, we have taken account of the views expressed and information provided by a number of stakeholders who indicated that a period of transition will be needed to enable Openreach to develop the capability to provide the new WLR Core Rental service, and also for other CPs to adapt their systems and plan appropriately for its introduction.

3.70 We are therefore proposing to phase the introduction of the new Core Rental service to allow for the practical system integration issues Openreach faces in introducing the new product, and the preparatory work required of other CPs. We have discussed the timing of the integration with stakeholders, including industry groups, and the Release 1400 proposed for July 2010 is considered appropriate and least disruptive to other developments of the WLR system.[23] We are consulting on this proposal (see question 3.1 below).

3.71 To achieve this, we are proposing a direction (see Annex 6) which will require BT to make the Core Rental service available, including the ability to include either residential or business directory entries, simultaneously with Release 1400. In this proposed direction we are proposing a back-stop date of 31 July 2010 to provide certainty and transparency to stakeholders on the timing of this development. In the event that changes to the requirement are appropriate (e.g. because of legitimate delay to Release 1400), Ofcom has the ability under section 49 of the Communications Act to modify the direction appropriately.

3.72 Until the availability of the new WLR Core Rental service at Release 1400, we will only require Openreach to offer a residential directory to comply with this first phase of the Core service. Openreach's current *WLR Basic* product will therefore be compliant with this requirement. Given Openreach's clear plans to phase out WLR2, we do not consider that it would be appropriate for additional costs to be incurred for development of this platform to support a new product. We understand from

[23] The March 1300 release would have been technically possible but this would have required other upgrades being re-prioritised.

Openreach that any development costs would be significantly increased should the core service need to be offered on WLR2.

The *WLR Premium* Charge Ceiling

3.73 In adopting this approach we are mindful that, until Release 1400, there will be no WLR service available with a business directory listing except *WLR Premium.*

3.74 We consider it important that business customers should be adequately protected from Openreach's ability to set excessive prices for business WLR services in the period before availability of the new WLR Core Rental service with the option of business directory listing. In order to ensure that businesses will have access to an appropriate product at a regulated price until then, we are proposing a new Condition which will establish the existing charge for business quality of service rental (i.e. *WLR Premium* at £110) as a ceiling. The proposed Condition includes a sunset clause to coincide with the availability of the new Core WLR Rental Service (currently scheduled for July 2010).

3.75 This charge was previously established as a ceiling in 2005, but the ceiling was withdrawn in September 2009 as a result of withdrawal of SMP conditions in the Wholesale Review. Because we believe it is important that business WLR customers are protected against excessive charges, we now propose to re-introduce the ceiling through the new Condition.

3.76 We consider that this charge ceiling can exist concurrently with the new Core Rental Service charge control, at least until the Core Rental Service is developed to include business directory listings. We do not consider that this imposes any inconsistent obligation on Openreach.

3.77 Openreach recognised in its response that there would be a transition period and that the control imposed on the new core rental would likely be in place before the full implementation of the core product. Therefore, Openreach offered to provide a voluntary commitment that it would not 'exceed the current ceiling for *WLR Premium* rental service until the WLR core functionality had been delivered'.

3.78 While we consider Openreach's proposal would provide CPs and customers with some level of assurance, in their responses other stakeholders have sought greater certainty.

3.79 As set out in Section 4, the ability of all customers to move between different care levels is important in constraining Openreach's prices for its premium service options. However, this constraint will be limited whilst a business directory listing is not available with the core service. The proposed new Condition will protect WLR business customers during this phase.

3.80 The proposed new condition has been drafted such that the sunset clause will end the ceiling obligation when Openreach introduces the new core rental service with the option of business directory listing (currently scheduled for Release 1400 In July 2010). In developing the draft new condition, we considered the appropriate timing for the ending of the obligation. We looked at two options – ending of the obligation when the core service is available providing flexibility for residential or business directory listings, and maintaing the ceiling obligation through to the end of the

charge control (March 2010). Our consideration of these two options is explained below.

Option 1 – withdrawal of WLR business charge ceiling simultaneously with the availability of the WLR Core service

3.81 This option would end the additional protection for business customers provided by the continuation of the current ceiling on *WLR Premium* to coincide with the availability of the new WLR Core Rental service with business directory listing – i.e. at Release 1400 scheduled for July 2010.

3.82 This option would provide the industry with a route map for the regulation of WLR services, and precision on the timing of withdrawal of the *WLR Premium* ceiling to coincide with the availability of the new WLR Core Rental service. This would also ensure that the current ceiling (£110) does not create an artificial constraint on the pricing of new WLR variants by Openreach – e.g. combinations of the new core rental service and care level options.

3.83 Some stakeholders have expressed concern that not all business customers will have migrated from WLR2 to WLR3 at Release 1400 (currently scheduled for July 2010) and that the current ceiling should be maintained beyond this date to protect them (we consider this option below). We understand that that full migration to WLR3 will not be complete at the scheduled date for Release 1400, and that around 30% of business users will not have migrated by that time according to Openreach's forecasts. We have also taken account of the information provided by stakeholders that a period of some months should be allowed for migration to the new WLR Core service.

3.84 We believe that the migration framework must provide adequate protection for all business users on WLR platforms. However, this does not necessarily mean that the current WLR business ceiling needs to be maintained after the new core service is available. In the event that the ceiling is withdrawn at that time, other remedies would still apply. For example, no undue discrimination requirements (SMP condition AAA2) and equivalence obligations would prevent undue discrimination in the provision of WLR services between customers or groups of customers.

Option 2 – partial withdrawal of the ceiling simultaneously with the availability of the WLR Core Service maintaining the WLR Business ceiling in place for WLR2 lines only for the duration of the WLR charge control

3.85 This option would require that the ceiling be withdrawn only insofar as it related to WLR3 lines, at the time of Release 1400. The ceiling, as it applied to WLR2 business lines would be kept in place for the duration of the control (i.e. to March 2011).

3.86 The reason for this would be to provide explicit protection of WLR2 business customers who have not migrated to the new WLR Core Rental service when it becomes available. As stated above, we believe the framework must provide adequate protection for all business users, and this option would provide complete price ceiling protection for any WLR business users who continue to use *WLR Premium* on the WLR2 platform for the duration of this charge control.

3.87 However, there is a danger that this protection would also create inefficient price signals in the market. This is because prices for the WLR Core Rental service can rise during the life of the charge control. Maintaining a price signal for WLR2 services may therefore create a perverse incentive against migration to WLR3.

Proposal for timing of withdrawal of the WLR2 business price ceiling

3.88 We have considered the relative advantages of both options for the timing of withdrawal of the WLR2 business price ceiling. On balance, we think that Option 1 is the better approach since we do not want to create a distorted pricing framework which could incentivise customers against migration. We recognise that some protection for the significant minority of WLR business customers who are forecast to remain on the WLR2 platform after Release 1400 (July 2010) is appropriate. We believe that SMP remedies which will apply to all WLR services – e.g. no undue discrimination and equivalence requirements – will provide adequate protection in the framework we are setting.

3.89 Therefore we propose to set the price ceiling on WLR business quality of service for WLR services until the introduction of the new WLR Core rental service. We propose to withdraw the ceiling simultaneously with the introduction of the new Core Rental Service. We are consulting on this proposal in question 3.2 below.

Question 3.1*: Do you agree with Ofcom’s proposal that Openreach be required to provide the full functionality for the WLR Core Rental service (i.e. including the option of business directory listing) at the time of the WLR3 software release – Release 1400? If you do not agree, please give reasons for your answer.*

Question 3.2*: Do you agree with Ofcom’s proposal for a new condition to cap the charge for WLR business level of service at its current level (£110) until the introduction of the new WLR Core Rental service with the option of business directory listing? If you do not agree with the setting of the charge ceiling, please give reasons for your answer. If you consider that the ceiling should not be withdrawn before the end of the charge controls (March 2010), or you believe it should be withdrawn at some other date during the charge controls, please give reasons for your answer.*

Section 4

Treatment of enhanced care service for WLR

Introduction

4.1 In this section, we set out proposals for further consultation on the controls for charges for enhanced WLR services – i.e. care level options.

4.2 We explain the outcome of our consultation to date on the regulation of charges for WLR care level options, and make proposals for regulation based on our analysis of the evidence, including stakeholder responses to the Wholesale Review [24] and the WLR Consultation.[25]

4.3 In summary, we are proposing to dis-apply:

- the basis of charges condition in relation to enhanced care level options for WLR; and
- the requirement for WLR charges to be based on LRIC+ in relation to enhanced care level options for WLR.

4.4 However, all other SMP conditions applying to this market will continue to apply to enhanced care level options and we are proposing to monitor the setting of such charges, with a view to preventing exploitative or unfair pricing. We will also have an opportunity to review this position in the next charge controls review prior to 31 March 2011.

4.5 Additionally, we are not immediately withdrawing the WLR charge ceiling direction[26] in so far as it applies to WLR rental (business quality of service). BT's *WLR Premium* product is constrained by this ceiling. We are consulting on the final withdrawal of this requirement as to whether this should be synchronised with BT's ability to provide business listings as part the new Core Rental service, or whether there should be an extended period of transition before its withdrawal (see Section 3).

Considerations

4.6 In the WLR Consultation, Ofcom set out three options for regulation of the enhanced care element of *WLR Premium*. The options were:

- Option 1 – applying cost orientation to the *WLR Premium* charge (i.e. the rental of the *WLR Premium* product) in total;
- Option 2 – applying cost orientation to the incremental part of the *WLR Premium* charge compared to the core WLR service, i.e. just the difference in charges related to the care level; and

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[24] http://www.ofcom.org.uk/consult/condocs/wnmr_statement_consultation/main.pdf
[25] http://www.ofcom.org.uk/consult/condocs/wlrcc/
[26] as set out in Annex 1 to the Statement entitled *Wholesale Line Rental : Reviewing and setting charge ceilings for WLR*

- Option 3 – not applying any cost orientation obligation, but giving guidance on how we might interpret other obligations on Openreach in the event of a dispute.

4.7 In relation to Option 1 we explained that a first order test of cost orientation is usually to establish whether a charge is between its cost floor measured by distributed long run incremental costs (DLRIC) and its cost ceiling, measured by distributed stand alone costs (DSAC).[27] We explained that the margin between DLRIC and DSAC for *WLR Premium* derived from BT's regulatory financial statements was wide (£72 - £139). We did not feel that such broad flexibility would offer meaningful protection to *WLR Premium* customers. Therefore we indicated that we did not favour this option and preferred the approach of setting a charge control on the core element of all WLR variants.

4.8 In relation to Option 2, we explained that applying a basis of charges obligation to the enhanced care element of *WLR Premium* only would potentially create very wide flexibility between DLRIC and DSAC, with DLRIC likely to be very close to zero and DSAC being recovery of the full cost for each care level event (e.g. maintenance visits). We did not feel that this would be a well targeted protection against excessive charges to customers.

4.9 On Option 3, we explained our analysis that customers would be afforded some protection from excessive charges by substitutability between different variants of WLR. We explained how, in the event that we choose not to apply an ex-ante basis of charges requirement on WLR care level options, Openreach would still be subject to the other SMP conditions applied to this market including the requirements to set fair and reasonable terms and conditions (Conditions AAA1 and AAA.10.1) and the complementary protection of competition law.

4.10 We asked stakeholders (question 3.4) for views on whether a basis of charges (cost orientation) condition should apply to enhanced care level services.

Remedies which currently apply

4.11 Following completion of the Wholesale Review, a number of obligations have been applied to Openreach in relation to the pricing of WLR.

4.12 The Wholesale Review found that BT had SMP in analogue and ISDN2 exchange line markets and concluded that there was a risk that Openreach had the ability to charge excessive prices in order to maximise profits.[28]

4.13 In order to address the identified market concern the Wholesale Review concluded that a basis of charges obligation should be applied to both the analogue and ISDN2 exchange line markets. We confirmed at paragraph 13.26 that this obligation would apply to all services within a given market, noting that this continued the previous regulatory approach imposed under SMP services condition AA3.[29] This obligation restricting Openreach's pricing of services within the market is also reflected in SMP

[27] For further detail on Ofcom's approach to cost orientation in the Wholesale review, see Annex 14 of the statement and further consultation document on the wholesale narrowband market review. http://www.ofcom.org.uk/consult/condocs/wnmr_statement_consultation/main.pdf.

[28] http://www.ofcom.org.uk/consult/condocs/wnmr_statement_consultation/main.pdf. See para 11.44.

[29] Now revoked; see Notification at Annex 7 to the Wholesale Review.

service condition AAA10.2 which requires WLR charges to be set on the basis of Long Run Incremental Costs (LRIC).

4.14 For completeness and ease of reference, all of the conditions which currently apply to WLR provision are listed at paragraph 2.16.

4.15 In this document we are deciding whether any individual services (including the treatment of enhanced care as standard for WLR Premium) should be removed from the basis of charges condition currently applied to the market as a whole, will be made within this review. As we are proposing to issue a direction under the Wholesale Review Statement SMP Condition with respect to cost orientation we are obliged to consult on the implementation of such a direction.

4.16 We have reviewed the nature of the value added WLR services provided by Openreach within the exchange lines market, and we set out our conclusions as to whether some or all of these service should remain subject to SMP Condition AAA3, as currently applied across the whole market. The value added services in question are the maintenance service options available to WLR customers.[30] In this section we consider whether these options for enhanced care should be subject to a basis of charges obligation.

4.17 Through its Service Harmonisation initiative, Openreach is currently developing new care level options to apply across a number of its regulated services. This means that the available options for WLR are likely to change in the near future. This is an important reason why we have excluded the option of setting a charge control for these enhanced care services at this stage. This does not mean that it might not be appropriate to impose a charge control on these enhanced care services in the future once the services are established if there are concerns about the levels of charges set by Openreach.

Responses to consultations

4.18 In its response to the Wholesale Review consultation document,[31] BT stated that it did not support the imposition of a basis of charges requirement for enhanced care options for WLR. It cited a number of factors in support of its position, including:

- in BT's view, enhanced care options do not meet the criteria required for imposition of SMP remedies, including:
    - there is no risk of excessive pricing by Openreach since customers can choose not to purchase these services;
    - a cost orientation requirement would not promote efficiency and may stifle efficient investment and product development;
    - a cost orientation requirement would not promote sustainable competition for similar reasons; and

[30] Openreach currently offers 3 levels of maintenance service options, with Level 1 being the default option available to customers at no extra charge. As well as being able to opt for Levels 2 or 3 which provide an enhanced level of care, customers use the 'expedite repair' service.
[31] http://www.ofcom.org.uk/consult/condocs/review_wholesale/

  - o a cost orientation requirement would not confer the greatest possible benefit on end-users, and may in fact be detrimental as a result of less service differentiation;

- in BT's view a cost orientation requirement for these services would be inconsistent with the Undertakings;[32] and

- in BT's view a cost orientation requirement would also be inconsistent with Ofcom's policy on Next Generation Access (NGA).

4.19 In its response to the WLR Consultation,[33] Openreach largely repeated the points made by BT in response to the Wholesale Review, and added that other regulatory safeguards constrain any unreasonable behaviour.

4.20 One other respondent to the Wholesale Review, COLT, was unsure about the imposition of a basis of charges requirement, and urged that any regulation should not result in cross-subsidies between residential and business customers. However, COLT also urged the imposition of charge controls in the event that rates for these services rise above the competitive level, and also that they should be subject to Equivalence of Input (EOI) requirements under the Undertakings.

4.21 Other respondents to both the Wholesale Review and WLR Consultation supported the imposition of a basis of charges requirement for enhanced care options for WLR. These respondents pointed to a number of factors in support of their positions, including:

- FCS noted that cost orientation would provide appropriate incentives for efficiency;

- Virgin Media noted that BT has SMP in the provision of these services, and that a cost orientation requirement is an appropriate safeguard in these circumstances;

- SSE, C&W and TTG said that a requirement for cost orientation for these services would not act as a disincentive to innovation as high returns are potentially available through the setting of rates at or close to stand alone costs (SAC); and

- Post Office expressed concern that absence of a cost orientation requirement might put vulnerable customers (for whom higher levels of care level are required) at risk.

Ofcom's analysis and conclusions

The Undertakings

4.22 In its response to both the Wholesale Review and WLR Consultation, Openreach referred to the treatment of unregulated services under the Undertakings. However, enhanced care options for WLR are currently regulated. They also fall within the EOI

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[32] http://www.ofcom.org.uk/telecoms/btundertakings/
[33] http://www.ofcom.org.uk/consult/condocs/wlrcc/

provisions of the Undertakings[34] and hence are required to be provided by Openreach to BT downstream divisions and to other CPs on an EOI basis. Openreach comments about unregulated services in its response to consultation therefore are not applicable to any element of WLR services.

NGA

4.23 We do not consider that a basis of charges obligation on WLR enhanced care options would be contrary to any principles for regulation of NGA set out in our regulatory statement '*Delivering super-fast broadband in UK'* (the NGA Statement).[35] The statement explains that decisions on price regulation for NGA services will be taken at the time of market reviews and on the basis of the particular market in question, and also sets out some general principles which we believe should apply to regulation of wholesale prices for NGA services – for example in relation to pricing flexibility and the appropriate level of reward for risk.[36]

4.24 We do not agree with Openreach's comment that a basis of charges obligation would be contrary to this position. It is worth noting that WLR is not currently provided on NGA platforms and so, were Ofcom to impose a basis of charges obligation, it would not directly affect any NGA deployment. Furthermore, the process of market review we are undertaking though the Wholesale Review and this consultation is fully consistent with the approach set out in the NGA Statement. Section 13 of the Wholesale Review explains how Ofcom has approached the question of WLR services provided over NGA architectures, i.e. that WLR requirements in a NGA environment where no copper remains should be interpreted as:

- A CP should be able to provide a wholesale narrowband service via the NGA network, such that it can support a Publicly Available Telephony Service (PATS) and can own the retail relationship with the end customer.

- However, this does not necessarily mean the existing WLR product needs to be replicated over NGA. Technology options that allow greater flexibility and innovation potential to CPs should be fully considered before the final product design is confirmed. [37]

4.25 In conclusion, it would be inappropriate to take decisions now on the precise form of regulation of any WLR type service provided on NGA networks, or of any value added components, e.g. care level options. The analysis and proposals we have developed through the Wholesale Review and this consultation are consistent with the principles and approach set out in the NGA Statement.

Market driven constraints on the pricing of WLR care level options

4.26 In the WLR consultation document and Wholesale Review we explained that there is some substitution between *WLR Premium* and *WLR Basic*. Our analysis showed that

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[34] The Undertakings set out the detail of BT's EOI obligations, including on WLR and can be found at http://www.ofcom.org.uk/telecoms/btundertakings/consolidated.pdf

[35] http://www.ofcom.org.uk/consult/condocs/nga_future_broadband/statement/
[36] http://www.ofcom.org.uk/consult/condocs/nga_future_broadband/statement/ see Section 8 in particular.
[37] http://www.ofcom.org.uk/consult/condocs/wnmr_statement_consultation/. See paras 13.23 – 13.25.

the two are parts of the same market and that *WLR Basic* is a suitable service for some business customers.

4.27 Based on this conclusion we believe that the level of charges for *WLR Basic* acts as a constraint on charge levels for *WLR Premium*, including the enhanced care element. This is because a proportion of the *WLR Premium* customer base would be able to switch to *WLR Basic* in response to any increase in the charge for the enhanced care level element of *WLR Premium*. This cannot be regarded as a competitive effect on both prices since both *WLR Basic* and *WLR Premium* are supplied by the same company (Openreach), but it is clearly a constraint on Openreach's ability to set the charges for the enhanced care element of *WLR Premium* at an excessive level.

4.28 This market definition and analysis from the Wholesale Review is instructive, but it should now be considered only in the context that the structure of WLR services will now change. A WLR core service will be available with flexible options for enhanced care. Therefore, the question for consideration is not whether the charge for the enhanced care element of *WLR Premium* is constrained by alternatives, but whether the charges for other enhanced care level options (existing and new) are constrained in this way.

4.29 Substitutability between WLR with and without enhanced care is not perfect because there are likely to be some customers for whom enhanced care is an indispensable part of the package they buy. However, the willingness of a proportion of customers to switch should also act as a constraint on levels of charges for all enhanced care packages since some customers have the option to purchase the core WLR service without enhanced care. Customers also have the option to purchase support services on a piecemeal basis when needed, e.g. using 'expedite repair', if they do not wish to have an ongoing support arrangement with Openreach.

4.30 In fact, we expect the constraint on charges for optional care levels through substitutability to increase under the new pricing framework for WLR. This is because the new core WLR service will incorporate the possibility of directory listings in either the residential or business directories. Whilst there is already evidence of business users finding *WLR Basic* to be a suitable alternative to *WLR Premium*, the availability of both options for directory listings under a new core service should make the ability to migrate between flexible options even stronger.

4.31 One respondent to the WLR Consultation (Post Office) expressed concern that substitutability between services would not benefit all customers, and that some vulnerable customer groups might be particularly disadvantaged by charge increases for enhanced care options if the WLR core service is not a viable product to serve them and there is no basis of charges regulation on enhanced care options.

4.32 We consider the proposed structure of the regulation should address this concern. One of the characteristics of partial substitutability between services is that it benefits all customers, provided that the supplier is not able to price discriminate between different users or groups of users which is very likely to be the case in this market.[38]

[38] In the case of WLR, Openreach has always operated uniform pricing. Given the 'white label' nature of the service, we believe it would be difficult for Openreach to do anything other than continue uniform pricing, and Openreach would need to demonstrate that any move away from uniform pricing would comply with the no undue discrimination requirements which apply to WLR.

It is only necessary for a proportion of customers to indicate their willingness to switch for there to be a constraining impact on charges, but all customers will benefit.

4.33 We believe that substitutability between WLR enhanced care options and the ability of some customers to opt out of enhanced care altogether does impose a market driven constraint on charges for these services.

Openreach development of new care level options

4.34 Through the Service Harmonisation initiative, Openreach is currently in discussion with industry about the development of new care level options for a number of its services, including WLR. We hope that this process will result in improvements to the range and quality of options available.

4.35 We note that BT and Openreach have expressed concern about the impact of a basis of charges obligation on incentives for innovation in development of new enhanced care services.

4.36 We agree that some risk to innovation may result from the imposition of an obligation that restricts or controls pricing, particularly as care level options are currently in development through the service harmonisation process. As explained in the paragraphs below, it would be difficult to establish robust guidance on floors and ceilings for these services and hence the interpretation of any basis of charges obligation would not be clear. We note the views of respondents that the potential for high cost ceilings would allow strong incentives for innovation. However, on balance, we believe that the absence of clear guidance on how a basis of charges requirements would be interpreted would create a risk that incentives to innovate would be diluted.

Available cost data

4.37 As noted above in paragraphs 4.7 and 4.8, available cost data on *WLR Premium*, and the nature of the service in question (care level options) suggests that there would be a very wide range of outcomes between the cost floors and cost ceilings for WLR care level options as measured by DLRIC and DSAC. We note that three respondents (C&W, SSE, TTG) noted the possibility of high cost ceilings in their responses to consultation.

Proposal – no basis of charges obligation for WLR enhanced care level options

4.38 We continue to take the view, as we did in the WLR Consultation, that the application of a basis of charges obligation using floors and ceilings would not be a well targeted remedy in this instance because the potentially very wide range of outcomes between DLRIC and DSAC would not be an effective constraint on charge levels. Also, as explained above, our analysis suggests that consumer harm will be unlikely to result from the absence of basis of charges obligations on WLR enhanced care level options because of the pricing constraint which arises from opportunities for substitution between WLR services and care level options.

4.39 Furthermore, we consider that the framework of regulatory controls on WLR set by the Wholesale Review[39] provides general safeguards which would allow Ofcom to

[39] http://www.ofcom.org.uk/consult/condocs/wnmr_statement_consultation/main.pdf

intervene in the event that these services are provided on a basis that was not fair and reasonable. In particular, Openreach has obligations to provide network access and new network access on fair and reasonable terms and conditions (Condition AAA1), to provide WLR (AAA10), to notify charges (Condition AAA6), and not to unduly discriminate (Condition AAA2). These conditions provide that:

- In the case of Condition AAA2, Openreach cannot discriminate unduly between persons or a particular description of persons in the setting of charges for these services. As explained above, this provides additional protection to customers who are unable to switch between services.

- In the case of Condition AAA6, Openreach must give notice of charge changes 28 days before they are implemented giving wholesale customers and Ofcom the opportunity to scrutinise the charges before they become effective.

- In the case of Condition AAA1 and AAA10, access services provided within this market must be fair and reasonable. This provides a general level of protection in relation to the general basis upon which services are offered, with the terms conditions and charges being specifically within the condition.

4.40 Taking account of all the evidence available to us, including submissions from stakeholders made in response to the Wholesale Review and WLR Consultation and on the basis of our analysis explained above, Ofcom's preferred approach for the regulation of enhanced care level options for WLR is to dis-apply current obligations on Openreach for cost orientation in relation to enhanced care levels for WLR. This proposal is set out at Question 4.1 below for consultation. We would propose to monitor the setting of such charges by Openreach, as set out in Question 4.2, with a view to taking appropriate action if the charges we considered to be anti-competitive.

Legal tests

4.41 The proposal in Question 4.1 would require a direction to dis-apply Conditions AAA3 and AAA10.2 for these services. A draft direction is at Annex 6. The effect of the draft direction is to define a class of enhanced services, and then to exempt this class of services from basis of charges obligations. In proposing to dis-apply the current SMP condition AAA3 to certain specified services we consider that the appropriate way of achieving this aim would be through a proposed direction made under the authority of SMP Condition AAA3.1.

4.42 The proposed direction is set out at Annex 6 which set out the list of services that are the subject of this proposal.

4.43 In proposing any direction Ofcom must be satisfied that the proposals within the direction are objectively justifiable, not unduly discriminatory, proportionate and transparent, in accordance with section 49(2) of the Act. We set out why we consider that the proposed direction fulfils those tests.

Objectively Justifiable

4.44 In assessing the direction to dis-apply SMP condition AAA3 to a specified set of service it is important to consider why the condition was applied to the market. The condition was set as part of the Wholesale Review on the wholesale analogue and wholesale ISDN2 exchange lines markets. In the review we considered that without

this condition BT would, in the market as a whole, have the ability to charge excessive prices in order to maximise profits.[40]

4.45 We have set out above in paragraphs 4.26 – 4.33 why we consider that Openreach is constrained from setting excessive prices in relation to this type of product by virtue of substitutability that exists between the different levels of care offered by Openreach and the level of care provided within the core, charge controlled service. This constraint is not present in other aspects of the market, and therefore we consider that it is justifiable to treat these services separately, given that the risk of setting prices at an excessive level, is significantly reduced for this set of products.

4.46 We have also considered an important rationale for ex ante regulation is an ability to set controls which are predictable and easily monitored. We discuss at paragraph 4.37 above, the difficulty in assessing costs for this type of product. The provision of enhanced care relies, in part, on Openreach being able to re-prioritise existing resources. Whilst the underlying cost of care services as a whole can be analysed it is difficult to assess the cost difference between services that are differentiated on grounds of priority. Although queuing theory and similar approaches can be used to assist in such an analysis, it remains difficult to accurately assess cost levels. In such circumstances it would mean that there would be potentially wide variations between cost floor and ceiling estimates and therefore a reliance upon a condition that required such estimates would fail to provide the predictability and certainty that should be achieved by ex ante obligation. We consider that the continued imposition of a basis of charges obligation where there remains an uncertainty as to how it may be applied would not be appropriate. The proposed direction removing this requirement and that uncertainty for specified services is objectively justifiable.

4.47 We also discuss at paragraph 4.36 above that there may be some risk to innovation should enhanced care services be subject to cost orientation. In proposing a direction to remove this obligation for such services, we are mindful of our section 3 duties to have regard to the desirability of encouraging investment and innovation when performing our primary duty, supporting the justification for this proposed direction.

Not unduly discriminatory

4.48 The proposed direction applies only to products provided by Openreach, so it affects all CPs and therefore their customers equally. We do not consider that the differentiation of regulation within this market creates unduly discriminatory regulation, as the products that we are proposing to remove from the basis of charges obligation are a set containing a subset of products that relate to one issue: the provision of enhanced service care. We are treating all products within this defined subset equally and therefore there is no ability for one set of consumers who purchase one type of care product to be unduly disadvantaged over another set of consumers who purchase a different care product.

Proportionate

4.49 We consider that the proposed direction is proportionate as we have recognised that the key driver for the implementation of the basis of charges obligation on the market as a whole, the risk of excessive pricing, is less likely to be present in respect of these services. It would be disproportionate on that analysis to continue to apply a remedy to these services. The exemption of these services from the requirement

[40] Paragraphs 5.80 and 11.44 of the Wholesale Review.

ensures that the regulation on this market remains targeted only where there is an identified competition concern.

4.50 Further, for the reasons set out above, we consider that the continued application of a control in circumstances where its application was unclear would not be consistent with the principle of proportionality.

Transparent

4.51 We consider that the proposed direction clearly sets out the position as to how the basis of charges obligation should apply to this market. We consider that we have clearly identified a class of services that we propose should be exempted from the obligation in order to ensure that it is clear and unequivocal as to when the obligation does not apply.

Question 4.1*: Do you agree that enhanced care levels should be removed from the basis of charges and cost orientation obligations imposed by SMP conditions AAA3.1 and AAA10.2, as set out in the proposed direction at Annex 6?*

Question 4.2*: Do you agree with Ofcom's proposal to monitor the setting of charges for enhanced care level options for WLR with the backstop of enforcement under other SMP conditions and Competition Law to prevent exploitative or unfair pricing?*

Section 5

WLR rental charges and underlying costs

Introduction

5.1 In this section we set out our approach to setting the core WLR rental charge. The key elements to this are based on :

- the cost modelling analysis, assumptions and the reasoning set out in the LLU Statement (and the First and Second Consultations to that Statement), adjusted as necessary for factors considered in the WLR Consultation, and the responses to that Consultation;
- setting charges by reference to current cost accounting and fully allocated costs (CCA FAC);
- maintaining consistency with the LLU charge controls; and
- maintaining an appropriate differential between the charges for MPF and SMPF+WLR. For productive efficiency, the difference in charges should reflect (or equal) the difference in LRICs.

5.2 In the WLR Consultation we explained our methodology for calculating the costs of the core rental service for the WLR charge control. This included separating the costs of the enhanced care element of *WLR Premium* (this analysis is set out in this Statement in Section 7), setting WLR charges based on CCA FAC costs, forecasting those costs as at 2012/13, and a glide path to that point for the duration of the control period.

Stakeholder views

5.3 Most responses to the WLR Consultation considered consistency between LLU charges and WLR charges to be important. Some, such as TTG, regarded a consistent approach as being absolutely crucial.

5.4 Post Office said that while consistency was ideal in principle, the target markets for both LLU and WLR should also be taken into account when setting the final WLR control. Post Office said that this would ensure that the resulting charges would encourage sustainable competition in all relevant retail markets.

5.5 We also asked whether respondents agreed with our analysis on the relative charges for LLU and WLR charges. Some responses agreed with our analysis. The views of those that did not are summarised below.

5.6 C&W noted that Openreach's Indicative Pricing for Service Harmonisation[41] brief indicates that 'Level 1' care is not applicable to, or available with, MPF. Comparing the price of the core WLR service with the price of the standard MPF rental is not comparing like for like, since the two products have different care levels. C&W said that Ofcom's analysis did not acknowledge this difference.

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[41] http://www.openreach.co.uk/orpg/news/generalbriefings/gen08409.do

5.7 While Openreach considered that both the MPF and WLR charges should be raised, it supported the differential between the charges.

5.8 TTG considered the differentials between the charges proposed for MPF and WLR/WLR+SMPF to be lower than the difference which would be implied by a LRIC approach. We address this point in detail in this section.

Ofcom's analysis and conclusions

Use of CCA FAC

5.9 CCA FAC has been used in other regulatory charge setting exercises as a consistent proxy for a long run incremental cost (LRIC) based approach, including in the current WLR charge ceilings, the Network Charge Controls and the Leased Lines charge controls. We have concluded that the reasoning (in those reviews and in the LLU Statement) apply equally here (in particular, these arguments were set out in detail in Section 5 of the LLU Statement and in Annex 4 of that Statement). In summary:

- CCA FAC is a widely understood concept and has been the anchor point for many previous price controls; and
- it uses data that can be reconciled to the regulatory financial statements which are published and audited.

5.10 In particular it is relevant that CCA FAC has been used in determining the appropriate charges for MPF and SMPF rental in the LLU Statement. For reasons explained in this statement, consistency in the setting of charges for LLU (MPF and SMPF) and WLR is of key importance. We therefore confirm the use of CCA FAC data for the setting of the WLR charge controls.

Consistency in the setting of LLU and WLR charges

5.11 Ofcom believes there is an important need for consistency in setting the prices for LLU and WLR to avoid competitive distortions. Our approach to ensuring consistency and, in particular that the differential in the charges between MPF and SMPF+ WLR is at least equal to LRIC measured on a consistent basis is discussed in detail in this section.

Care levels

5.12 As described in the WLR Consultation, the Service Harmonisation initiative is currently being undertaken by Openreach in conjunction with the Office of the Telecoms Adjudicator (OTA) and interested CPs. The aim is to rationalise the current set of eight distinct service levels for WLR and LLU and to provide care levels with identical terms for WLR and LLU. Currently, the standard of care (for example, in terms of speed of fault repair) for MPF is specified in a different way to WLR.

5.13 While specified differently, the current standard of care for MPF (and also for SMPF) is generally higher than for WLR. We consider that this is reflected in our cost stacks, as we have higher repair costs for MPF than WLR. In response to the point made by C&W, we therefore believe that our analysis adequately reflects the current differences in care level options between LLU and WLR.

Appropriate differential between MPF and WLR and WLR+SMPF

5.14 As set out in Annex 4 of the LLU Statement, we consider the differential between MPF and WLR+SMPF to be particularly important. We consider that the differential should reflect cost differences because of the risks of distorting the choice of wholesale products. We do not consider it appropriate to base charges on demand based factors (such as Ramsey pricing which would set charges according to elasticity of demand) as MPF and SMPF+WLR are alternative wholesale inputs for CPs to provide the same retail services. We consider that setting charges so that the differentials broadly reflect incremental cost differences would be consistent with removing any productive efficiency distortions and that setting charges on the basis of CCA FAC is consistent with achieving this. We consider that dynamic efficiency considerations also support the use of CCA FAC.

5.15 TTG in its response argued that the differential between MPF and WLR was also important and that the gap between the charges for the two services should not be less than the difference between the LRICs of the services in order to promote voice competition based on MPF. TTG presented estimates of the differentials between MPF and WLR/WLR+SMPF that were around £20 higher per line per year than our CCA FAC forecasts used in the setting of the LLU charge controls. TTG's estimates include in the WLR charge the costs of migrating from the TDM technology to NGN technology and the full NGN combi card costs.

5.16 We consider that the differential between MPF and WLR would be an important consideration if the size of the differential appeared likely to create significant productive inefficiencies. However, in practice we think it unlikely that any productive inefficiency would occur if the difference in the charges for WLR and MPF did not reflect LRIC because it is not clear that it would be economic for a LLU operator to provide voice only services given the economies of scale involved relative to the value of the service.

5.17 Nevertheless, we have undertaken an assessment of the costs and charges for MPF and WLR with a view to establishing whether the differential between them covers LRIC. We set out below in more detail why we consider that the MPF and WLR charges result in a differential that broadly reflects the difference in the LRICs.

<u>Differences in approach to WLR charge between Ofcom and TTG</u>

5.18 There appear to be two fundamental differences between TTG's approach to assessing the differentials in costs and charges between MPF and WLR and our own. These are:

- we do not consider MPF to be an input to WLR; and
- we consider that the share of NGN costs allocated to voice should not result in charges being set above the stand-alone cost of providing voice services.

5.19 We expand on each of these points below and then consider the implications for the differential between MPF and WLR.

MPF is not an input to WLR

5.20 It is not the case that WLR is the sum of MPF and various additional items, such as the line card. Rather, MPF and WLR are different products and each has product-specific costs. Some of the differences, such as the line card, tend to increase the

WLR charge above the MPF rental charge. But other differences tend to increase the price of MPF relative to WLR.

5.21 If we calculated the WLR charge using the MPF charge as an input, then the WLR charge would have to increase substantially. This is because it would need to include the product-specific costs associated with MPF, as well as the product-specific costs associated with WLR. We consider it more appropriate to calculate both the MPF charge and the WLR charge based on the costs involved in the provision of each product.

5.22 That MPF is not an input to WLR has been Ofcom's consistent position since the Strategic Review of Telecommunications in 2005.[42] In the final statement on the Strategic Review of Telecommunications, we explained this as follows:

> 'We consider this would undermine WLR-based competition. WLR connection and rental charges would have to increase substantially, since they would have to include the product-specific costs associated with LLU. This would in turn be reflected in the line rental paid by consumers.
>
> Requiring WLR to use full MPF as an upstream input would also impact on those broadband services which are dependent on PSTN lines. Broadband services based on shared MPF or asymmetric IPStream would effectively be paying LLU product costs twice.
>
> The current LLU systems and processes are also not dimensioned so as to handle the total volume of narrowband transactions generated by BT Retail and by other providers.'

WLR charge should not have to cover the total costs of shared NGN elements

5.23 Our aim in setting charges is to protect consumers from excessive charges. The cheapest way to provide voice services for the period for which we are setting charges would be to maintain the existing TDM technology. Given this, we consider that one reasonable approach to setting charges would be to do so on the basis of maintaining the TDM technology.

5.24 Alternatively, if we were to consider NGN technology using multi-service access nodes (MSANs) to be the Modern Equivalent Asset, we would have to decide how to recover the MSAN costs since MSANs can provide both voice and data services. We consider that in this scenario the costs recovered from voice only customers should be capped at the level that would be implied by hypothetical continued use of the existing TDM technology. This is because it would hypothetically be possible to continue to provide voice only services with the existing TDM technology. The reason multi-service technology would be used if the network were rebuilt today is that it lowers the total costs for providing both voice and data. We do not consider it appropriate that voice only customers should pay more as a result of using more cost effective technology.

[42] See Ofcom's response under the proposal that 'WLR should use full MPF as an input' in Figure 2 on page 51 of the Strategic Review of Telecommunications Final Statement: http://www.ofcom.org.uk/consult/condocs/statement_tsr/statement.pdf

5.25 This is consistent with the approach endorsed by the Competition Commission in its assessment of 2G and 3G costs in its assessment of mobile termination costs.[43] In its Determination of January 2009, the Commission made the point that, in a competitive market, the introduction of a new and more efficient technology should not lead to higher prices for an existing service.

Estimating the differential in incremental costs between WLR and LLU services

5.26 In its response to the WLR Consultation, TTG argues that on a LRIC basis, the cost differences between MPF and WLR/WLR+SMPF would be about £20 higher than the difference in charges set by Ofcom. TTG refers to its Appeal of decisions in the LLU Statement for details of the breakdown of this differential.

5.27 In the following sections, we consider each of the items TTG lists in its comparison. For each item we set out our view of what the likely range for the cost difference would be on a LRIC basis.

5.28 It should be recognised, however, that any assessment of the LRIC differential is, by its nature, approximate. An estimate of the incremental cost differentials needed to ensure productive efficiency needs to deal with various practical difficulties. For example, the additional investments required to provide voice services are typically 'lumpy'. There are large steps in costs as new pieces of equipment are needed that then serve hundreds of customers. Strictly, the incremental costs of additional users may be fairly flat, and then suddenly be extremely high as a new piece of equipment is needed. This might be the case even in the long term because pieces of equipment are not divisible. The most sensible approach to take in these circumstances is likely to be to even out the spikes in costs by a form of averaging. However, even when lumpiness has been eliminated by averaging, there will be variation in costs by exchanges, given the economies of scale likely to be present.

5.29 In these circumstances, one approach to estimating the relevant incremental costs of WLR over MPF to achieve productive efficiency might be to identify separately the costs of exchanges that have been unbundled (or are likely to be unbundled in the future). WLR specific costs per line would be expected to be lower in unbundled exchanges than for all exchanges, given that the larger exchanges (with lower average cost per line) are more likely to have been unbundled. That larger exchanges tend to be unbundled is clear from the fact that around 35% of BT's exchanges have been unbundled, but these cover nearly 85% of premises.[44] But data just for unbundled exchanges is not easily assessable. Our estimates of the LRIC differentials therefore involve WLR at all exchanges. This may mean that for unbundled exchanges the difference in the incremental costs is overstated, as the true cost in those exchanges is likely to be lower than average.

5.30 For some components of the difference, such as the line card, it is possible that our estimate may capture some costs that are incremental to the service as a whole rather than to a small increment in the number of lines. This will also tend to overstate the LRIC differences for small changes in volumes.

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[43] http://www.catribunal.org.uk/files/CC_Determination_1083_H3G_1085_BT_220109.pdf See in particular Section 2.9

[44] See Figure 4.38 in the 2009 Communications Market Report http://www.ofcom.org.uk/research/cm/cmr09/cmr09.pdf

5.31 These points illustrate the practical issues that arise in trying to adopt an appropriate LRIC approach. It is because of these practical difficulties that we consider it reasonable to consider the LRIC differentials only in an approximate fashion.

Line card costs

5.32 Line cards are the electronic equipment that telephone lines connect to in the local exchange. They represent an important input for WLR but are not required for the provision of MPF. BT currently uses TDM technology. This involves PSTN line cards that only recognise voice traffic. The costs are therefore directly attributable to WLR services.

5.33 At the time of the Second Consultation, BT was planning to move to 21CN (or NGN) technology. This transition was expected to be largely complete by 2013. As part of this migration, BT planned to replace most PSTN line cards with ‘combi cards’ (using MSANs). These could be used by multiple products or services in three ways:

- to generate a voice only service, using only the voice capability of the card (currently WLR);
- a data-only service using only the data capability of the card (BT does not currently provide such a service); or
- a voice and data service using the full capability of the card (currently WLR and broadband).

5.34 The cost of a combi card is the same however it is used. As with the existing PSTN line cards, combi cards would be owned by BT Wholesale, who would pass the cost on to Openreach.

5.35 We explained in the Second Consultation that Openreach had estimated the line card cost to be recovered via the WLR charge on the basis of the number of services provided.

5.36 On this basis, WLR and broadband would both be treated as one service. As a result, the combi card cost would be divided by the total number of services forecast. We considered that this methodology was reasonable and that the resulting unit cost values were also reasonable. However, after the Second Consultation, BT suspended its plans for the roll-out of 21CN. It is currently proposing to continue with the TDM technology for voice services until 2020 at the earliest.

5.37 We therefore considered what the costs would be of maintaining the existing TDM technology. This was not straightforward. While potentially there could be cost savings by not installing combi cards, PSTN line cards are reaching the end of their life and must be replaced or refurbished. Delaying replacement past their useful life or refurbishing will result in higher maintenance costs which could increase overall costs.

5.38 In the WLR Consultation we proposed using the figures in the Second Consultation. These were based on a weighted average of PSTN line card costs and a per service allocation of 21CN combi cards (when BT’s plans involved 21CN gradually replacing PSTN over the period). If combi cards are regarded as the most economical way of continuing to run the TDM network, their costs can be used as estimates of the costs of maintaining the existing TDM technology. This approach yields a per line cost

which is within the range of PSTN line card costs in the regulatory accounts in recent years[45] and broadly constant in real terms over time.

5.39 Alternatively, we could consider the case where BT replaces PSTN cards with combi cards as part of a plan to replace the PSTN network with its planned 21CN network. In this case, combi cards are the Modern Equivalent Asset, but the charges for their use needs to reflect (i) that they are installed to support both voice and broadband services, and (ii) that the move to combi cards is necessary only if the network is required to support more services than just voice. In Ofcom's view, three principles are relevant to the question of how these costs should be recovered. They are consumer protection, incentives to invest in efficient cost reducing technology, and the efficient choice of inputs.

5.40 In relation to the issue of customer protection, it would be inefficient for an investment in new lower cost technology to result in customers having to pay more for their service than they did previously (see paragraph 5.25 and footnote 46). This suggests that it would be equitable and efficient to cap the charge for the combi card when used for voice at the cost of continuing to provide voice services over the dedicated voice network.

5.41 In relation to the second principle, cost reducing investment is induced if prices are left unchanged by the introduction of new technology, as this gives the firm an incentive to minimise costs. By contrast, if the introduction of new technology were allowed to lead to higher charges, inefficient investment could be encouraged.

5.42 In relation to the issue of the efficient choice of inputs, we believe that it is important that the charging arrangement is consistent with the minimisation of the total costs of providing voice and broadband services. This implies that the charge for a combi card for voice-only services should be capped at the cost of providing voice services (i.e. a PSTN line card). If the charge were set above this level, CPs could be induced to use MPF and install a PSTN line card. This could lead to the total cost of cards, including subsequent upgrades of lines for broadband being greater than if combi cards were installed on all lines in anticipation of a significant number of lines being upgraded to broadband.

5.43 Thus, in this situation, for reasons of consumer protection and efficiency, we consider that it would be appropriate to cap the costs recovered from voice only customers at the level that would be implied by hypothetical continued use of the existing TDM technology.

5.44 In 2012/13, the resulting CCA FAC of a voice line card is £12.30 per line per year.[46] On a LRIC basis, we might expect this figure to be slightly lower than this. We note that when BT prepared LRIC estimates in its regulatory accounts, the LRIC estimate

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[45] In 2004/05 in BT's Current Cost Financial Statements the line card cost was £14.89 (though this was based on assuming a rate of return of 13.5%). In 2005/06, it was £12.32. In 2006/07, it was £11.41. In 2007/08 the combined PSTN and service-allocated combi card cost was £11.71 and in 2008/09 it was £10.43.

[46] The figure of £12.30 is as shown in Figure A4.5 of the LLU Statement. This is on a slightly different basis to the £12.04 cost shown in paragraph A5.29 of the WLR Consultation. The difference relates to the way we have spread the adjustment we made to cost allocations within Openreach (as described in paragraphs A6.156 to A6.181 of the LLU Statement) between different categories of cost. While the breakdown between the components is different, the total cost for the WLR service is the same in each case.

for the line card was around 90% of the CAA FAC figure. If this ratio were to hold when the CCA FAC is £12.30, it would imply a LRIC of around £11.

5.45 On the other hand, we accept that the CCA FAC figure we are using may involve some fully depreciated equipment. This could mean that a figure of £11 would be an underestimate of the true economic cost of providing voice services

5.46 Taking these factors into account, we consider that the LRIC of the line card is likely to be in the range of £11 to £13 per line per year. This compares to TTG's assumption of £16.50, based on the full costs of providing the service with NGN technology.

Accommodation and power

5.47 TTG proposes an additional £3.32 per line per year to cover the costs of the accommodation to house the voice equipment and the associated power, air conditioning and other services required to run the voice equipment.

5.48 The PSTN line card cost we have used already includes accommodation, power and associated costs. It is therefore inappropriate to include a separate allowance for these costs.

Migration

5.49 TTG argues that the WLR charge should include around £7 per line per year for migration costs. For avoidance of doubt we should clarify that these migration costs are unrelated to connection charges. For WLR, separate connection charges are levied when a consumer switches provider which are independent of the rental charge. In contrast, the migration costs TTG considers should be included concern moving from the PSTN network to the 21CN network.

5.50 We noted in the WLR Consultation that BT would not be incurring significant migration costs for the period for which we are setting charges because of the changes to its plans for the roll-out of 21CN.

5.51 However, even if BT were actually incurring these costs, we do not consider they should be recovered through the WLR charge for the following two reasons:

- These migration costs are driven by the move from the old technology to a new technology. The principle discussed above that a new technology should not increase costs for existing users who could have continued to be served with the old technology is therefore relevant. This would imply it is inappropriate to allow costs to increase as a result of the new technology (see also para 5.25 and footnote 47 above).

- A key part of the rationale for NGN technology is to reduce costs in the core (conveyance) network by having a single voice and data network rather than two separate networks. If migration costs should be recovered at all it should therefore be through prices of core (conveyance) services. We have recently reset the Network Charge Controls[47] and considered that these migration costs should be recovered through cost savings from the new more efficient network,

[47] http://www.ofcom.org.uk/consult/condocs/review_bt_ncc/statement/nccstatement.pdf

not price rises (even for core conveyance services) now. This is also consistent with our view in the 2005 Network Charge Controls Review.[48]

5.52 We recognise that there may need to be some costs as a result of maintaining the existing technology. However, we consider that these maintenance costs are likely to be small and can be considered to already be included in the existing line card costs and not as additional items in the WLR cost stack. We therefore do not think it is appropriate to include any additional migration costs in the WLR cost stack.

Frame costs

5.53 TTG argues that MPF and WLR should have the same frame costs. For SMPF, it assumes additional frame costs that are £10.61 per year on a LRIC basis. This implies that the LRIC costs for WLR+SMPF should be more than £10 more than for MPF.

5.54 TTG quotes the figures in BT's 2007/08 regulatory accounts for the cost of the main distribution frame (or MDF). These are as follows (all on a per line per year basis):

- MPF £6.54 (£3.22 capital, £3.32 current)
- WLR £3.33
- SMPF £9.80

5.55 BT's 2008/09 regulatory accounts are now available. These have the following figures:

- MPF £8.60 (£4.92 capital, £3.68 current)
- WLR £2.90
- SMPF £8.60

5.56 There is a significant variation between the two years. The differential between WLR and MPF frame costs in BT's 2007/08 regulatory accounts is £3.21, while for the 2008/09 accounts it is £5.70.

5.57 The figures in the regulatory accounts compare to a difference of £1.79 between WLR and MPF in our CCA FAC cost forecasts for 2012/13 for the difference in direct frame costs, or £2.66 if exchange repair costs are also included.

5.58 While the amounts vary, all the above figures show MPF involving more frame costs than WLR. This is because MPF currently involves more jumpering on the exchange than WLR. This results in more use of the main distribution frame and more of the associated costs of maintenance and fault repair. This might suggest that on a LRIC basis, the frame related costs for MPF would be higher than the WLR. We might expect the difference on a LRIC basis to be slightly less than on a CCA FAC basis, as the CCA FAC basis will also include allocations for overheads. Our analysis assumes a range between zero and £2 as the additional frame (and exchange related) costs of MPF compared to WLR (per line per year).

[48] http://www.ofcom.org.uk/consult/condocs/charge/statement/statement_ncc.pdf

5.59 TTG has argued that in the future a different option for jumpering for MPF will be used that requires only a single jumper and makes use of an in-line test access matrix (or evoTAM). This would mean MPF would use the main distribution frame to the same extent as WLR.

5.60 However, no MPF lines are currently jumpered in this way, and we have seen no evidence to suggest that this is how most MPF lines will be connected in future networks. This is because it is not obvious that this way of connecting to testing equipment will ultimately be less costly than the current method. The evoTAM arrangement is likely to require an intermediate frame to be installed in the exchange (probably near the evoTAM) to provide flexibility. It is unclear whether this arrangement will result in lower costs for MPF users, and hence whether they would want to use this way of jumpering. Nevertheless, in our LRIC estimates below, we have included a zero difference between frame costs for MPF and WLR as the bottom end of our range.

5.61 In terms of comparing MPF and WLR+SMPF, the figures TTG quotes from the BT's 2007/08 regulatory accounts show that WLR+SMPF is £6.59 more expensive than MPF in respect of frame costs. The 2008/09 regulatory accounts have a difference of £2.90. This is similar to the difference in our CCA FAC forecast for 2012/13 of around £3 for frame costs and exchange repair costs. TTG argues that on a LRIC basis the differential should be more than £10.

5.62 However, we have considered the argument that on a LRIC basis, WLR+SMPF would not involve any more frame related costs than MPF. It could be argued that both MPF and WLR+SMPF currently involve two jumpers and four points of connection on the MDF, and that the frame related costs should be similar. This might suggest that at one extreme, there is no difference in the LRICs for MPF and WLR+SMPF for frame related costs. But if in the future the jumpering for MPF is as TTG argues, then MPF will involve half the jumpering of WLR+SMPF. In this case, we might expect MPF to have lower frame costs on a LRIC basis than WLR+SMPF.

5.63 In our range for the differences in LRIC below, we have assumed that WLR+SMPF involves, at one extreme, the same frame costs as MPF and at the other extreme has costs that are higher by £3.

Tie cables

5.64 TTG notes that the tie cable costs we have included are largely depreciated and that this may understate the actual LRIC cost. TTG argues that this will mean the differential between WLR and MPF is also understated. It estimates that WLR should be £3 higher than MPF to cover the costs of the tie cable. It assumes a relatively expensive 21CN tie cable is used.

5.65 But MPF currently involves more tie cables than WLR. Because of the way the test access matrix is accessed, there are three tie cables associated with each MPF line, compared to only one for WLR. One of these tie cables is paid for separately by the MPF user. If we considered the costs on a LRIC basis, this would leave two tie cables to be included in the MPF charge. So it is reasonable to assume that tie cable costs would be higher for the MPF LRIC than the WLR LRIC. There would be no reason to assume the use of a relatively expensive 21CN tie cable for this, as a cheaper tie cable would be sufficient. The annual cost of an additional cheaper tie cable may be of the order of £1 per line per annum. This is based on similar assumptions to those used by TTG for amortising the connection costs of the extra tie cable and usage.

5.66 If in the future MPF is delivered in the way TTG proposes, MPF and WLR might involve the same number of tie cables. In this case, if a tie cable is included in the WLR charge, but paid for separately for MPF, we would expect the WLR charge to be higher than the MPF charge. However, we have seen no evidence to suggest this is a likely outcome.

5.67 Moreover, even if we did assume, as TTG argues, that next generation jumpering would be different, we would not consider it appropriate to include the costs of a 21CN tie cable in the WLR charge. 21CN tie cables are suitable for broadband, but much cheaper tie cables are sufficient for providing a voice only service. Given the principle we set out earlier about the existing TDM technology acting as a cap on the WLR charge control, it would be more appropriate to assume a cheaper tie cable in the WLR product.

5.68 WLR+SMPF involves three tie cables, as does MPF. But SMPF users pay for two tie cables separately whereas MPF users only pay for one. In terms of the rentals on a LRIC basis, it would therefore be reasonable to expect MPF to involve higher tie cable costs than WLR+SMPF. Taking all the above into account, at one end of our range, we have assumed that the LRIC for MPF is £1 per line per year higher than for SMPF+WLR.

5.69 The situation would be different if we assumed, as TTG argues, that in the future the way MPF is delivered is different. If this were to happen, then SMPF+WLR may involve one more tie cable than MPF. In this case, we have assumed that the LRIC for SMPF+WLR would be £1 per line per year higher than for MPF. This gives us a range for -£1 to +£1 for the difference between MPF and WLR+SMPF for tie cables.

Directories

5.70 It could be argued that the directory (or phone book) cost allocation is not relevant when considering not distorting the choice of wholesale input. This is because directories are delivered by BT regardless of whether an end consumer is supplied with a service using MPF or WRL/WLR+SMPF. In fact, the directories are delivered to all households and businesses regardless of whether they have a BT line. BT's costs may therefore be the same whether a line uses MPF or WLR/WLR+SMPF.

5.71 On the other hand, the cost of providing directories could be regarded as relevant because WLR includes a contractual commitment for Openreach to provide a phonebook to each end user, whereas MPF does not. In terms of the incremental cost of providing each service, as defined in the contracts, we may therefore want to include the costs of providing a directory.

5.72 If we did include an incremental cost for directories, then it would be less than the fully allocated cost. There is probably a significant fixed cost element involved in compiling directories. In its assessment of the difference in incremental costs, TTG assumed a cost of £0.50 per line per year to cover the costs of printing and distributing a directory. This seems a reasonable approach, and we have adopted the same assumption in our assessment.

Product management, servicing and fault repair

5.73 TTG argues that WLR involves higher product management, servicing and fault repair costs than MPF. TTG argues that WLR involves many more capabilities and features than MPF. It argues that the provision of WLR involves assets and resources that are additional to MPF, which it sees as 'simply the copper wire'. For

the reasons we set out earlier, we reject this view that WLR involves MPF plus additional services. We do not regard MPF as an input to WLR. Rather, MPF and WLR are two distinct products and each has its own product-specific costs. For the reasons given below we consider that MPF will have higher product management, servicing and fault repair costs than WLR.

5.74 We accept that there are some WLR specific product costs. However, some of these WLR specific costs are connected with providing voice features and will be included in the line card costs. In terms just of product management and servicing, our CCA FAC estimates have almost the same figures for WLR and MPF. It would be surprising if the costs for MPF were significantly lower than for WLR. WLR is an established product with users who have fairly homogenous demands, leading to comparatively low product development and management costs. In contrast, MPF users tend to have diverse requirements, and accommodating these tends to increase product development and management costs.

5.75 In terms of faults, our CCA FAC figures are based on the following usage factors to apportion fault related costs to products:

- MPF: 1.22
- WLR Residential: 1.15, and
- WLR Business: 1.00

5.76 These usage factors are based on Openreach's actual experience of reported faults. They show that overall MPF involves more faults than WLR. We recognise that TTG has presented evidence that faults on its WLR lines are higher than on its MPF lines. However, based on the information from Openreach on actual reported fault rates, TTG's experience does not appear to be representative of lines as a whole.

5.77 Another reason to expect MPF to have higher repair costs than WLR is that there is generally a higher standard of care associated with MPF (and also for SMPF) than WLR. In particular, the fault repair standard for an MPF line is for it to be repaired within 40 hours (Monday to Sunday), compared to 96 hours for a *WLR Basic* line (see the table in Annex 7 of the WLR Consultation).

5.78 In terms of the CCA FAC for network repair and the allocation for the service management centre for assurance, the costs for MPF are around £3 per line per year higher than WLR (using an average of residential and business lines). Other differences in the CCA FAC costs for WLR and MPF, such as for sales and service level guarantee payments, are minimal.

5.79 We are satisfied that the costs of product management, servicing and fault repair are higher for MPF than WLR. We consider this will be the case on a LRIC basis as it is on a CCA FAC basis. However, we consider that the LRIC difference may be smaller than the CCA FAC difference (which is around £3). We consider that the incremental costs for these items for MPF are likely to be between £1 and £3 per line per year higher than for WLR. This compares to TTG's assumption of a higher LRIC for WLR of £1.50.

5.80 Turning to the comparison between WLR+SMPF and MPF, we would expect SMPF+WLR to have higher product management and systems costs as it involves

two products rather than one for MPF, and hence is associated with two sets of such costs.

5.81 In terms of network repair, both sets of products include the higher cost of repair associated with broadband and both SMPF and MPF involve relatively high contractual standard of care. But WLR+SMPF may be expected to have somewhat higher costs as there will be two interfaces between Openreach and the provider(s) for repair issues rather than one.

5.82 We consider that a range of £3 to £4 for the LRIC differential is reasonable. The upper end of this range is in line with TTG's estimate. It is also the same as the difference in our CCA FAC estimates for network repair, service management for assurance, sales and product management. The lower end of this range is on the assumption that the LRIC estimates may be below the CCA FAC estimates because of the likely higher proportion of overheads included in CCA FAC than LRIC.

Summary of LRIC differentials

5.83 TTG has estimated that the difference in incremental costs between MPF and WLR is around £32 per line per year, and that the difference between MPF and WLR+SMPF is around £45 per line per year. This involves differentials that are around £20 higher than implied by the FAC CCA forecasts used to set the charge controls.

5.84 Based on our own estimates, we consider that the differentials proposed by TTG are very substantially in excess of what the differentials would be on a LRIC basis. Figure 5.1 below sets out TTG's view of the differentials alongside our own.

Figure 5.1: Comparison of LRIC cost differences

	TTG		**Ofcom**	
2012/13, per line per year	MPF vs WLR	MPF vs WLR+SMPF	MPF vs WLR	MPF vs WLR+SMPF
Line card	£16.50	£16.50	£11 to £13	£11 to £13
Accommodation and power	£3.32	£3.32	-	-
Migration	£6.99	£6.99	-	-
Frames	£0.00	£10.61	-£2 to £0	£0 to £3
Tie cables	£3.00	£3.00	-£1 to £1	-£1 to £1
Directories	£0.50	£0.50	£0.50	£0.50
Product management, servicing and fault repair	£1.50	£4.00	-£3 to -£1	£3 to £4
Likely range for LRIC differential	**£31.81**	**£44.92**	**£8 to £12**	**£15 to £20**

5.85 In the LLU Statement we considered that the £25 difference between the CCA FAC for MPF and WLR+SMPF in 2012/13 was unlikely to be less than the LRIC differential. We considered the likely range for the LRIC differential was £20-25.

5.86 Having considered the differentials again after taking a final view on the WLR specific costs, we believe the differences in LRICs are lower than we previously estimated. We consider that the LRIC differential between MPF and WLR+SMPF is likely to be

in the range £15 to £20. This compares to a forecast difference in CCA FAC we have used to set the glidepath for prices of around £25 in 2012/13.[49] We are therefore confident that the difference between the MPF and WLR+SMPF charges we have set is certainly not smaller than the LRIC differentials.

5.87 The difference in CCA FAC for MPF and WLR in 2012/13 according to our current modelling is around £10, which is broadly similar to our estimate of the LRIC differential of £8 to £12.

5.88 A key reason for the differences between our view and that of TTG is that we do not consider that it is appropriate to base the WLR charge on all of the costs of providing voice services with NGN technology.

Avoiding excessive increase in charges to consumers

5.90 We have also considered whether we should set charges so that the differentials are more closely aligned to LRIC than is shown by the above analysis. This would involve reducing the SMPF charge and increasing both the WLR and MPF charges. Compared to the charges we have set, this would have the effect of reducing the differential between MPF and WLR+SMPF, and holding the differential between MPF and WLR constant. This would have stronger incentives for productive efficiency. It would also be consistent with our view that productive efficiency is a more important consideration for MPF vs WLR+SMPF than for MPF vs WLR, as it would be ensuring that the MPF vs WLR+SMPF differential was more in line with LRIC. These changes might also be consistent with allocative efficiency, if demand for broadband is more elastic than demand for fixed lines.

5.91 However, we do not consider that it would be appropriate to increase the MPF or WLR charges further by means of a steeper glidepath or (in the case if MPF) a bigger adjustment to charges in the first year. Operators using MPF make a significant contribution to the competitiveness of the retail broadband market and hence to the benefits which consumers get from broadband service. We explained in the LLU Statement that our chosen glidepath for prices reflected the need to 'avoid any dislocation in the market and…place stronger cost efficiency incentives on regulated companies',[50] as well as the objective of reducing 'the potential distortion to the choice between MPF and WLR+SMPF'.[51] In addition, 'the impact on LLU operators was a concern and has been an input to our consideration of the appropriate price path'.[52] In our judgement therefore, the consumer interest would not be best served by a larger increase in the MPF charge than we have proposed.

5.92 Similarly, a reasonably priced WLR product is important to downstream competition, as we recognised in the recent retail narrowband market review statement[53]. As a result of the growth in competitive pressures based largely on the use of WLR, we have now deregulated the Retail Narrowband Market. This was despite the fact that

[49] Based on our cost modelling. It is important to note that both the WLR and LLU charge caps will end in March 2011 and so the modelling will be reviewed ahead of that.
[50] http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/statement.pdf see para 5.9.
[51] http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/statement.pdf see para 5.12.
[52] http://www.ofcom.org.uk/consult/condocs/openreachframework/statement/statement.pdf see paras 5.17-5.19
[53] See paragraph 1.7 in the retail narrowband market review statement http://www.ofcom.org.uk/consult/condocs/retail_markets/statement/statement.pdf

BT retains a relatively high market share. A significant increase in WLR charge could affect the competitive conditions in the retail market.

5.93 Secondly, in addition to economic efficiency, we also need to consider wider policy considerations. Raising the WLR charge even further would tend to increase charges for voice only consumers, including those on social telephony schemes. We therefore need to consider the relative levels of charges taking a range of considerations into account, which are broader than pure economic efficiency.

5.94 On balance, we do not consider it would be appropriate to raise the WLR charge further. We consider that the charges we have set already narrow the wholesale differentials sufficiently to avoid significant economic inefficiencies.

Conclusions

5.95 Having taken account of all the evidence available to us, including the helpful contributions of stakeholders submitted in their responses to consultation, we have concluded that the charge controls for the WLR core service should be set on the basis of CCA FAC cost standard.

5.96 We are satisfied that the differential in charges between MPF and SMPF+WLR is sufficient to cover the difference in LRICs for these services.

5.97 We do not believe there is a need to align charges more closely to the LRIC differential as this would require charge increases to the dis-benefit of consumers and not result in significant economic efficiencies.

Section 6

Ancillary services controls

Introduction

6.1 This section describes our approach to the remaining WLR analogue services, that is those other than the core rental and enhanced care level options.

6.2 It sets out our determinations on whether and how any charge control should be applied. The key cost related assumptions employed in our analysis, and a detailed explanation of the cost base, are set out in Section 7.

Summary of conclusions

6.3 We have determined that it is appropriate to consider some service set-up and migration charges, specifically existing line transfer and new line connection charges, as falling within the scope of the charge control.

6.4 The specific services that we are imposing price controls on are:

- existing line transfer from one WLR provide to another; and
- new line connection (for a residence/office without a BT line).

6.5 In relation to the existing line transfer charge, we will continue with our current approach of setting the transfer charge below Fully Allocated Cost (FAC) but within our estimated range for the incremental cost of providing the service. We believe a low transfer charge is an important factor in promoting competition in the retail market. In the first year the transfer charge will be increased from £2 to £3.

6.6 We will continue with the current practice of recovering the remaining transfer costs, ie those not recovered by the charge, through a small increase in the WLR rental charge (the impact of this is set out in detail in Section 7). With respect to the new line connection charge, we have identified that the existing charge is substantially above the current FAC. In recognition of this, we will implement a one-off adjustment to the connection charge to reduce it from the current level of £88 to £67 in the first year. Further reductions will be realised through a glide path approach. We consider that a one-off adjustment is necessary due to the large discrepancy between the current charge and the FAC cost.

Existing line transfer charge (WLR to WLR)

6.7 An existing line transfer happens when an active line is transferred between WLR providers (including BT Retail).

6.8 As stated in the WLR Consultation, the current charge ceiling for existing line transfers is set at £2. In the First WLR Statement,[54] Ofcom considered that it was appropriate to continue with the approach adopted in 2002 by Oftel when the original

[54] Wholesale Line Rental: Reviewing and setting charge ceilings for WLR services, 24 January 2006, paragraph 3.65 and 3.66, http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/statement.pdf

charge ceiling was set. At the time there was a concern that high transfer charges might act as a barrier to switching and therefore Oftel decided that some of the costs of a transfer should be recovered through the line rental charge. In the WLR Consultation we discussed several different options and proposed that we should continue with this approach.

Necessity of a charge ceiling for the transfer charge

6.9 In the WLR Consultation we noted that at present, service providers do not directly pass on the £2 transfer charge to consumers by way of an additional charge when they switch providers. CPs rely on recovering this cost through their retail line rental margin and additional revenue streams such as calls outside of retail bundles.

6.10 In the absence of a charge ceiling and if the full cost of the transfer charge was passed to CPs at the point of gaining a new customer we consider that it is possible that this will lead to the introduction of an up-front transfer charge recovered directly from the customer, or contracts containing Minimum Contract Period (MCPs) or Early Termination Charges (ETCs).[55] The availability of low upfront charges incurred by a gaining CP creates an environment where CPs can compete on terms and conditions other than price. Several CPs active in the retail market offer customers no contract tie-in periods and therefore those customers are not currently subject to MCPs or ETCs. A low transfer charge is an important aspect in maintaining this level of choice for consumers.

6.11 We also noted that a substantial element of the CCA FAC cost for the service was fixed and economic efficiency requires only the incremental cost of transactions to be covered by the cost of the activity.

6.12 While we acknowledged changes in the retail market since the last review, particularly increased competitiveness, we considered that there was still a role for a low transfer charge to support this environment. We believe we can set such a charge without impacting static efficiency. Therefore, we proposed to continue with the current methodology of setting a low transfer charge and recovering the remaining costs through the line rental, taking account of volumes and churn rate.

Stakeholder responses

6.13 While a majority of respondents agreed with our proposal to retain the existing methodology of setting a transfer charge ceiling and recovering the remaining transfer costs through the line, several respondents were opposed to this approach.

6.14 Post Office stated that ‘by recovering the transfer costs primarily through the line rental, Ofcom is unduly penalising loyal customers’. It also argued that the difference in migration costs for consumers when moving from LLU to WLR is much higher than transferring between WLR CPs and this was ’unfairly favouring’ CPs that offer LLU delivered voice which creates ‘an artificial barrier to switching’. Post Office suggested that the cost structures for LLU and WLR should be more aligned or ‘additional

[55] The Ofcom review of additional charges statement published in December 2008, outlined Ofcom’s view on MCPs and ETCs, amongst other charges. Ofcom stated that while it did not disagree that there were legitimate reasons why service providers might require customers to adhere to MCPs and ETCs, we do consider MCPs to be core terms (which means they must be transparent and prominent at point of sale) and ETCs to be non-core terms (which means they are subject to the fairness test as outlined in the statement). http://www.ofcom.org.uk/consult/condocs/addcharges/statement/

exchange based work should be considered as an overhead that is required to facilitate migration which is then absorbed as a general cost'.

6.15 TTG disagreed that the current market conditions justified our proposed methodology going forward, stating that the 'benefits of this meddling is now much less'. It also questioned this treatment for WLR transfers, when there was not a similar treatment for MPF connections (i.e. WLR to MPF and MPF to MPF) and WLR conversions (i.e. MPF to WLR).

6.16 Conversely, while agreeing with our basic approach, SSE did not feel we went far enough in setting a low transfer charge, stating that it would 'like to see the approach further developed to cover all transfer costs through the rental charge'.

6.17 Sky agreed that the 'unique characteristics' of the market make it 'pragmatic and in consumers' interests for some of the line transfer charge to be included in rental', but that Ofcom should be 'well aware of the competitive distortion it has created by not structuring MPF charges in the same way'.

6.18 Openreach accepts the 'continuation of the existing approach as one that avoids disruption', but notes that it should be able to recover its full efficiently incurred costs.

Ofcom's conclusion

6.19 We recognise that our approach will result in a slightly higher WLR line rental charge (£1.46 in 2010/11 – see section 7) than if we recovered all the allocated costs from the WLR transfer charge, and that this will marginally raise total charges for customers that switch infrequently. However, we consider that the level of the WLR transfer charge is important to the competitiveness of the retail narrowband market. A significant increase in the WLR transfer charge could increase switching costs, which might change the competitive conditions in the retail narrowband market. A competitive retail market benefits consumers, including those who do not switch frequently. Benefits can include lower prices, customer service improvements or product innovation. In order not to undermine the competitive retail market, we believe that our approach to the WLR transfer charge is appropriate.

6.20 We do not agree that there is a strong case for setting the absolute levels of the WLR transfer (WLR to WLR) and WLR conversion (MPF to WLR) at the same level. A WLR transfer is very different to a WLR conversion (or to a MPF connection, i.e. WLR to MPF). A WLR transfer is simply an electronic transfer, which has low incremental costs. In contrast, a WLR conversion requires physical engineering to re-jumper the main distribution frame and therefore has far higher costs. As a result, we consider it reasonable that the two charges should be different, reflecting the underlying cost differences. We do not accept that this is favouring MPF over WLR.

6.21 We recognise that our approach to WLR transfers is different to that for WLR conversions and MPF connections (i.e. WLR to MPF and MPF to MPF). While we have set the MPF connection on the basis of CCA FAC, we have recovered some of the WLR transfer costs on a CCA FAC basis from the rental charge.

6.22 We consider that different approaches are justified by different circumstances. Firstly, setting charges based on CCA FAC would result in the WLR transfer being considerably out of line with incremental costs, whereas this would be much less the case for MPF connections. For WLR transfers, the incremental cost is likely to be a small proportion of the CCA FAC forecast. This is because a large part of the CCA FAC cost base is composed of fixed system development costs. In contrast, for MPF

connections, the incremental cost is likely to be a large proportion of the CCA FAC forecast, as a large part of the cost will be the re-jumpering in the exchange. Given this difference, we think it is reasonable to consider the implications of setting the WLR transfer charge equal to CCA FAC in more detail.

6.23 Secondly, it is more important for competition to roll some of the CCA FAC costs of the WLR transfer into the WLR charge than is the case for MPF. WLR is the key wholesale remedy that has enabled the retail narrowband market to become competitive. It is still fairly common in the retail narrowband market for consumers not to take out fixed term contracts. While we have found the market to be competitive, BT still has a high market share. Significant changes to the WLR transfer charge could have affected the SMP assessment. In contrast, MPF is associated with the provision of voice and broadband, where minimum contract periods are the norm. When there are minimum contract periods, the split between rental and connection charges makes a smaller difference to the competiveness of the market. Given that we do not think the balance of rental and connection charges is as critical for MPF, we have adopted a different approach.

6.24 After careful consideration of the responses to consultation, Ofcom will continue with the approach of setting a below FAC charge for transfer with the remaining costs recovered from the line rental.

Charge ceiling for the transfer charge

6.25 The next consideration was whether we should maintain the existing charge of £2 or whether we should vary the charge, and if so to what level.

6.26 Given our preference is for some support for transfer costs, we proposed the following options:

- reducing the existing charge;
- maintaining the £2 charge; or
- increasing the charge (but below full cost).

6.27 There was no evidence that a reduction in the transfer charge was required to support competition. The existing charge allows competing CPs to offer services without MCPs or ETCs and thus provides the competitive support that we have argued is still required.

6.28 We considered a key factor to be the size of the transfer charge as a proportion of the monthly line rental charge and our estimates suggested this proportion has decreased over time. The £2 charge was about 20% of a typical retail monthly rental charge in 2006 but is now about 17%, and a £3 charge would be slightly over 20%. We would expect this trend to continue as retail prices increase in line with general price movements. This decrease would imply that the support for market entry and competition provided by the transfer charge has increased over time and will continue to do so if it is left unchanged. In line with our earlier argument we consider that this is unnecessary.

6.29 Accordingly, we considered that it would be reasonable to increase the transfer charge at least to a proportion of monthly rental charges broadly equivalent to the proportion when it was originally set in 2005 (i.e. £3) and for that charge to increase over time in line with the core rental charge.

Stakeholder responses

6.30 Of the seven stakeholders who responded to this question, all except Openreach disagreed with our proposal to move the transfer charge from £2 to £3. However, of those six remaining responses, there was a range of views as to what the correct transfer charge should be.

6.31 On the one hand, TTG was concerned that at £3 the transfer charge was too low and could result in an inefficiently high level of switching, with ‘too many’ WLR to WLR transfers. It said it was not clear that the £3 would cover incremental costs. This was because we had said in the WLR Consultation that the cost of a transfer is about £13.50 (on a CCA FAC basis), and around two-thirds of this are system development costs. TTG considered that this implied that the incremental costs are at least £4.50.

6.32 On the other hand, a number of companies argued that we had not provided sufficient evidence to justify an increase from £2 to £3.

6.33 In disagreeing with our proposal, C&W stated that ‘providers of retail line rental services currently absorb the cost of the transfer charge, so an increase of 50% is not insignificant and would impact margins’. SSE argued that ‘Competition, effective customer choice and quality of service to customers, whatever their starting levels, would in our view quickly reduce in a market environment where suppliers – and their retail customers – had to pay material transaction charges to move away from their current supplier’.

6.34 One confidential respondent argued that the ‘one-off increase is a significant shift in proportionate terms and no scientific estimate is given of the likely effect on competition…..the transfer charge should remain at £2, or alternatively, the price should be adjusted gradually’.

6.35 FCS agreed that it was important to minimise barriers to switching by setting transfer charges as low as possible and stated that the charge should be retained at £2. Contrary to this view, Openreach believes ‘that the continued need for artificially low transfer charges is questionable and notes that it must retain the ability to fully recover its efficiently incurred costs – in this case primarily via the rental charges’. It supports the move of the transfer charge in the direction of FAC.

6.36 SSE believed the charge should be reduced to zero rather than being increased. It noted that Ofcom said that a large proportion of the transfer costs are fixed system-related costs (as would be expected from a computer-based transfer system). It said it was therefore not clear of the economic grounds for increasing the charge made on a per-transaction basis for using the system.

6.37 Post Office, while not advocating a particular charge level, argued that ‘the driver behind setting the transfer charge should be as an aid to promote the ability to switch between providers, this should be on a technology neutral basis’.

Ofcom’s conclusion

6.38 We do not believe it is appropriate to reduce the transfer charge to zero. There is an incremental cost to transfers. A zero transfer charge could result in an inefficiently high level of switching, as customers would not be paying the costs they were causing through switching. A high level of switching would result in more costs that would need to be recovered through the WLR Core Rental charge. There might have been a case for lowering the transfer charge if retail competition

would not have happened without it. But as we have found the retail market to be competitive, we do not consider there to be a strong argument for reducing the transfer charge now.

6.39 The incremental costs of transfer are not amenable to a precise estimate but we estimate them to be within a range of between £2 and £4.50. This is considerably less than the CCA FAC costs of around £13.50. Approximately two thirds of the FAC figure is due to allocations of system development costs. However, the other third of the CCA FAC cost stack also includes some fixed cost elements.

6.40 While there is a risk that the proposed new £3 charge does not cover incremental costs, we would not consider it appropriate that there should be a larger increase now. Increasing the transfer charge from £2 to £3 is already a 50% increase in the charge. Given stakeholder comments on the proposed increase, we consider that a larger increase at this time may impact adversely on competitive conditions in the retail market. Subsequently, we propose to increase the transfer charge in line with the WLR Core Rental service.

6.41 We consider that our approach, therefore, is consistent with economic efficiency, while ensuring that the market is not unduly disrupted. The charge will also maintain the opportunity for consumers to take direct advantage of competitive choice maintained, without increases in contractual burdens.

6.42 We have decided therefore to set the transfer charge at £3 with annual indexation in line with the core rental charge.

New line connection

6.43 The new line connection charge is paid by customers who have no active telephone line connected to BT's network at a premise.

6.44 Customers must pay the new line connection charge in order to take-up a WLR service, regardless of whether they choose BT Retail or a third party CP as their service provider.

6.45 The current new line connection charge set in 2006 is £88. Our analysis in the WLR Consultation found that the CCA FAC for connections is approximately £36, which is £52 below the current charge ceiling.

6.46 The fall in underlying costs was driven by efficiencies within Openreach and a re-assessment of common cost apportionment since the 2006 review. Similar factors have led to the revision in the cost base and charges of the new provide charge for MPF noted in the LLU Statement.

6.47 In most cases, Ofcom's approach to setting charge controls is to use glide paths over the period of the controls. However, in this case, given the scale of adjustment required for the charge, we considered in the WLR Consulation that there was a strong argument for an initial one-off reduction in the charge followed by a glide path.

6.48 We considered that if we did not apply a one-off adjustment to set the ceiling for the first year, prices would need to fall much more sharply over the course of the control. In considering the scale of any proposed adjustment we were also conscious of the relationship between new line provision for WLR and MPF customers. The LLU Statement imposed a substantial one off adjustment to the MPF new provide charge from £99.95 to £76. We did not consider that there was any argument to adjust

charges in a manner that would increase the incentive to connect a WLR line compared to an MPF line or the converse.

6.49 As discussed in Annex 5 of the WLR Consultation, there is some uncertainty over the appropriate volumes for new connections in the final year of the control. The BT estimated volumes drop by over 50% from about 760,000 to around 230,000. It is possible that this reflects uncertainty caused by changes to the 21CN timetable. Our proposed range set out in the WLR Consultation incorporated either volumes remaining at the 2011/12 level in 2012/13 or dropping to the BT estimate in 2012/13. We sought stakeholder views on the potential outlook with respect to volumes.

Stakeholder responses

Setting a charge ceiling

6.50 Of the seven stakeholders who responded to this question, all agreed that Ofcom should continue to set a charge ceiling for new connections.

One-off adjustment

6.51 With regards to our proposal to impose a one-off adjustment for the first year of the charge ceiling and then a glide path, a majority of respondents agreed with this approach. One confidential respondant disagreed, stating that imposing a glide path, without a one-off adjustment, would ‘prevent “shocks” to the market and competitive environment’.

Relationship with LLU

6.52 Of the six stakeholders who responded to this question, there was a mix of arguments as to whether it is appropriate for Ofcom to consider the relative charge of new line connections for LLU and WLR.

6.53 C&W and FCS both agreed with our proposal. C&W stated that it did not believe the ‘relative charge for MPF line connection and WLR line connection is as important as the relative charges for line rental. However, it may make sense to approximately maintain the differentials that exist today in order not to distort the decision making process of CPs’. Openreach also felt this was a ‘sensible and proportionate’ approach and on 3 August 2009, it notified the market that it was intending to implement a revised connection charge of £67 in accordance with our proposal.[56]

6.54 Post Office and SSE both argued that the charge should reflect FAC and should not be kept artificially high to maintain the current differential with the corresponding LLU charge. Post Office is concerned this unduly favours LLU delivered voice products. SSE understands that LLU connections ‘involve more work and are therefore more expensive’.

6.55 TTG pointed to Ofcom’s FAC analysis for new provides which states that in 2012/13 WLR new provides cost £36 and for MPF it is £46. It said that ’given WLR involve

[56] On 3 August 2009, Openreach requested Ofcom to consider waiving the price notification period so it could implement a price change from 1 October 2009. We published a consultation on 21 August 2009, http://www.ofcom.org.uk/consult/condocs/waiver_bt_wholesale/ and issued a statement on 17 September 2009 consenting to the reduced notice period, http://www.ofcom.org.uk/consult/condocs/waiver_bt_wholesale/statement/

more components and activity than MPF logically one would expect the MPF cost to be lower than the WLR one'.

Ofcom's conclusion

6.56 Clearly, it is important that Openreach's charges reflect the costs of providing a service. However, as stated in the consultation, we believe that where the differential between the current charge and CCA FAC is substantial, the combination of a one-off adjustment and glide path is appropriate. In determining what the initial one-off adjustment should be, we felt that a reasonable benchmark was the current price differential with MPF new provides. We considered that our proposal to decrease charges to £67 in year 1 moved the WLR charge significantly closer to the FAC charge (50% of the overall decrease required), while maintaining an existing pricing relationship which should serve to limit potential distortions between the two products.

6.57 We do not accept TTG's argument that it would be logical to expect the MPF new provide to be cheaper than the WLR new provide. We consider that a MPF new line costs more than a WLR new provide. The reason is that frame provision costs are higher for MPF, as MPF involves more jumpering on the main distribution frame than WLR.

6.58 Therefore, after taking into account responses to the consultation, Ofcom has decided to set a charge ceiling for WLR new line connection charges and apply an initial one-off adjustment to £67, followed by a glide path.

Services excluded from the charge control

MPF to WLR conversion

6.59 Currently the charge for converting a line using MPF to WLR is £38.

6.60 In the WLR Consultation we stated that there were two options open for consideration as part of the review in relation to the WLR conversion charge.

6.61 The first of those was the direct imposition of a charge ceiling for this service. However, we were concerned that the relatively small volumes in this service would make it difficult to determine a reliable and robust estimate of the underlying units costs.

6.62 Instead we proposed to rely on cost orientation. We also indicated that we considered that the existing relative level of charges for the WLR to MPF new connection and the MPF to WLR transfer was appropriate.

Calling and network features

6.63 We did not consider that it would be appropriate to include calling and network features within the scope of the proposed charge control. We argued that given the significant reduction in prices implemented by Openreach, there did not seem to be a compelling reason for Ofcom to consider increasing regulation of these services by introducing a charge control.

Other charges

6.64 The remaining charges are prevalidation, conversion from ISDN to WLR and cancellation charges.

6.65 The prevalidation charge applies to all WLR lines and enables a CP to confirm prior to a ‘like for like’ order being placed, how the end user’s line is configured and whether there are products connected that are incompatible to the WLR offering. The current prevalidation charge is £2. As set out in the WLR Consultation, while this charge does apply to all service requests and must be performed by Openreach to facilitate a request, we do not propose to include this charge within the scope of the charge control. The £2 charge has remained unchanged since 2006 and is subject to a cost orientation obligation. We considered that the cost orientation obligation has been a sufficient control for this charge to date and is therefore likely to continue to be an appropriate approach going forward.

6.66 The conversion charge applies when customers who currently purchase an ISDN line wish to convert to a single analogue line. The current ISDN to analogue conversion charge is £70. The level of conversions from ISDN to analogue is very low and it would seem disproportionate given the frequency of these conversions to impose regulation beyond the cost orientation obligation. Furthermore, Ofcom is not aware of any issues with regards to the provision of or the price of this conversion charge. We therefore took the view in the WLR Consultation that the cost orientation obligation has been a sufficient framework for this charge to date and that it is likely to be an appropriate approach going forward.

6.67 With regard to the cancellation charge, where Openreach has incurred costs involved in preparing to deliver a service, we did not consider that it is unwarranted for Openreach to recover these costs through reasonable cancellation charges. As a vast majority of a cancellation charge is likely to include costs related to engineering work and Openreach will need to potentially ‘reverse’ some of the work completed to cancel an order, we did not propose to include these charges within the scope of the charge control.

Stakeholder responses

6.68 Of the seven stakeholders who responded to this question, five agreed with Ofcom’s proposal to exclude other migration and calling and network charges from the scope of the charge control.

6.69 TTG did not agree with Ofcom’s proposal to exclude the MPF to WLR conversion charge from the charge control. It stated that it believes ‘given BT’s incentive and track record of anti-competitive behaviour, Ofcom must put in place strict rules to prevent pricing abuse’. TTG also commented on our proposal to apply a cost orientation requirement (and not a charge control) to the charge for WLR to MPF conversion. Our rationale for proposing this approach was that the relatively small volumes would make it difficult to determine a reliable and robust estimate of the underlying units of costs. TTG argued that while the volumes ‘though smaller than WLR to MPF connections are still significant (~400,000 in 2012/13) and …the activities are very similar to the WLR to MPF connection cost (which Ofcom believes can be reliably estimated)’. It considered our proposals to be flawed in a number of ways. It considered that Ofcom should put in place a rule that required that the MPF to WLR conversion charge is exactly the same as (or above) the WLR to MPF connection charge unless Openreach provides adequate and cogent reasoning otherwise.

6.70 Post Office argued that migration and calling and network features should be covered by the charge control as this would 'create the appropriate incentives for Openreach to be innovative in seeking new ways of delivering WLR as efficiently as possible'.

6.71 In relation to calling and network features, TTG noted that Openreach's reduced-pricing trial period had finished and stated that it presumed 'Ofcom would re-consider its proposals in this light'.

Ofcom's conclusion

MPF to WLR conversion

6.72 We have given careful consideration to TTG's proposal to require that the MPF to WLR conversion is exactly the same as the WLR to MPF connection charge. We recognise that if there were a significant difference between the two charges, there could be an argument for bringing them into line given the similarity in input costs. However, we do not consider it is necessary for the two charges to be set equal given that these are still different services.

6.73 We have therefore decided to continue to rely on the existing cost orientation requirement. Until recently, this has resulted in the MPF to WLR conversion charge being equal to the WLR to MPF transfer charge. Since the recent increase in the WLR to MPF transfer charge, there is now a difference between the two charges. Given that the two services appear to be similar and to involve the same engineering effort, we consider that it is likely to be reasonable within the cost orientation obligation for Openreach to raise the MPF to WLR conversion charge to be in line with the WLR to MPF transfer charge. We will continue to monitor the differential between the charges and if there emerges a material differential for a long period, we will consider reviewing the level of the MPF to WLR conversion charge.

Calling and Network Features

6.74 We have noted TTG's concerns regarding calling and network features. In August, Openreach concluded its reduced pricing trial on these features, with a view to implementing significant and longer term price reductions from September.[57] Following the trial, Openreach issued a pricing notification on 4 September 2009, which advised industry of the new wholesale prices for calling and network features effective from 1 January 2010.[58] All features were reverting to their trial pricing levels, except for call waiting, caller display and three-way calling, which will remain at their pre-trial pricing.

6.75 We asked Openreach to provide us with volume and demand data for the features which demonstrated the impact of the trial pricing on take-up. During the trial period, while some features showed a modest increase at the lower pricing levels (and indeed volumes for some features actually decreased), call waiting, caller display and three-way calling showed a stronger link to the price and this was reflected in take-up. However, the strength of this increased demand for the latter 3 services was a concern. Openreach advised that significant incremental capital expenditure would

[57] See Openreach response, response to question 5.4, page 23 http://www.ofcom.org.uk/consult/condocs/wlrcc/responses/

[58] See http://www.openreach.co.uk/orpg/pricing/notificationDetails.do?data=lMu0XOzQTUxzWnrHGAL7tszXrpVASdKX13NNq0asbdb33FkRprdkPimbVIJEBnnx

be required to support the additional demand for these services at the lower (trial level) price points, which would be difficult to justify given this is a legacy system.

6.76 In light of the information provided by BT (as set out in paragraph 6.75) and taking account of Openreach's permanent price reductions for many calling and network features, we have concluded that our proposal to exclude these services from the scope of the charge control remains appropriate. These services will therefore not be subject to charge control.

6.77 We note that Openreach has reverted to pre-trial price points for call waiting, caller display and three-way calling. It is clear that the demand/price relationship for these services is sensitive and any charge controls based purely on input cost would not be effective. We have and will continue to encourage Openreach to consider alternative pricing strategies to identify if there are options which would allow it to introduce sustainable price reductions.

Section 7

Unit cost determination

Introduction

7.1 This section sets out our assessment of the costs of providing the new WLR Core Rental Service. As set out in Section 2, we rely for our decisions in this statement on the analysis and assessments set out in the LLU Statement and accompanying annexes and the First and Second Consultations, as well as our WLR Consultation.

7.2 Specifically this section sets out:

- our cost estimates for residential and business WLR for the four years to March 2013;
- how we have reviewed the assumptions in light of responses to the WLR Consultation;
- how we have derived estimates of the cost of an aggregated WLR service;
- how we have adjusted these estimates to deduct the costs of providing services that may now be charged separately and hence derived the cost for the core WLR service; and
- how we have derived the additional costs that need to be recovered by the core WLR Core Rental service charge to cover the remaining WLR Transfer costs not covered by that charge.

Cost estimates for residential and business WLR

7.3 Our approach to the determination of the costs for the WLR services is based on CCA FAC principles.

7.4 As we explained in the LLU Statement, we consider that it is appropriate to use a four year period as the basis for the modelling of forward costs. We consider that the four year period allows us to take a medium term view of the impact of changes in costs, volume and efficiency levels. We also consider that it is appropriate to use cost estimates, provided by Openreach at our request as the starting point for our own financial analysis.

7.5 In summary in the LLU Statement, we

- set out Openreach's cost estimates at an aggregate and unit cost level;
- described Openreach's approach to the estimate of its costs, which includes the calculation of its costs in 2007/08 and projected cost estimates to 2012/13;
- set out the key assumptions made by Openreach to project future costs;
- demonstrated that the base year costs are consistent with audited financial data; and

- provided Openreach's explanations for the main movements in its cost estimates between 2007/08 and 2012/13.

7.6 We considered that Openreach's cost projections are based on a logically sound approach and provided a sensible basis for the modelling of future costs. We have therefore used Openreach's model to inform our estimate of unit costs. Specifically, we:

- Obtained, on a confidential basis, functional versions of these models;

- Spent significant time with Openreach and its consultants to ensure that we fully understand the mechanics of the model;

- Reviewed model user manuals and obtained thorough explanations of key aspects;

- Tested the interaction of volumes, task times, FTE assumptions, average salaries, fault rates and visit ratios to ensure the models produced predictable outputs that could be understood;

- Reviewed the allocation basis, to ensure that they are reasonable and are applied as described;

- Reconciled the base year forecasts back to audited financial data;

- Ensured that all movements in costs during the period could be explained by simple analysis based on an understanding of future changes in demand and cost behaviour;

- Prepared our own estimates of future costs on a CCA FAC basis, by rolling forward audited financial data from the 2008 current cost financial statements and ensured that the outputs from Openreach's model were consistent with these estimates.

7.7 The estimates of the costs for the individual WLR residential and premium services as derived from the Openreach Pricing Framework Review model were set out in Annex 5 of the WLR Consultation.

7.8 We set out below in Tables 7.1 to 7.4, total costs and revenue and unit costs for WLR residential and WLR business services.

Table 7.1: CCA costs and revenues for WLR Residential, assuming prices remain fixed in nominal terms

	2007/08 £'m	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	**1,774**	**1,688**	**1,631**	**1,599**	**1,381**	**1,267**
Pay	310	309	271	254	234	215
Line card and Tams	194	192	193	198	179	152
Accommodation	161	159	146	148	134	126
Stores, contractors, Service centre etc	84	78	71	69	59	52
Corporate Overheads	62	61	55	50	45	41
IT (ex depn)	84	84	73	68	61	56
Fleet	58	57	51	50	43	38
Other	14	7	7	7	6	6
Operating Cost	**967**	**948**	**865**	**844**	**761**	**685**
EBITDA	807	740	765	755	620	582
Depreciation inc Holding gains	161	438	363	288	279	277
EBIT	**647**	**302**	**403**	**467**	**341**	**305**
ROCE%	13%	6%	9%	10%	8%	8%
Mean Capital Employed	**5,044**	**4,760**	**4,670**	**4,751**	**4,247**	**3,969**
Volumes	**17,596**	**17,007**	**16,196**	**15,880**	**13,715**	**12,585**

Table 7.2: Unit WLR Residential Operating costs and depreciation

	2007/08 £	2008/09 £	2009/10 £	2010/11 £	2011/12 £	2012/13 £
Revenue	**100.84**	**99.26**	**100.68**	**100.68**	**100.68**	**100.68**
Pay	17.64	18.19	16.74	15.98	17.05	17.04
Line card and Tams	11.04	11.31	11.89	12.49	13.06	12.08
Accommodation	9.13	9.36	9.01	9.33	9.74	10.01
Stores, contractors, Service centre etc	4.76	4.59	4.36	4.33	4.32	4.15
Corporate Overheads	3.53	3.61	3.38	3.18	3.31	3.30
IT (ex depn)	4.76	4.94	4.51	4.26	4.44	4.42
Fleet	3.31	3.37	3.12	3.16	3.16	2.98
Other	0.78	0.39	0.40	0.43	0.41	0.47
Operating Cost	**54.95**	**55.77**	**53.42**	**53.15**	**55.48**	**54.45**
EBITDA	45.89	43.49	47.26	47.53	45.20	46.23
Depreciation inc Holding gains	9.14	25.74	22.40	18.12	20.32	22.04
Operating Cost inc depn	64.08	81.51	75.82	71.27	75.79	76.48

Table 7.3: CCA costs and revenues for WLR Business, assuming prices remain fixed in nominal terms

	2007/08 £'m	2008/09 £'m	2009/10 £'m	2010/11 £'m	2011/12 £'m	2012/13 £'m
Revenue	**646**	**641**	**579**	**483**	**549**	**539**
Pay	93	95	79	63	76	75
Line card and Tams	64	65	62	54	65	59
Accommodation	50	51	44	38	45	46
Stores, contractors, Service centre etc	26	25	21	18	20	19
Corporate Overheads	19	19	16	13	15	15
IT (ex depn)	25	26	22	17	20	20
Fleet	18	19	15	13	15	13
Other	5	3	2	2	2	3
Operating Cost	**300**	**302**	**262**	**218**	**259**	**249**
EBITDA	346	339	317	265	291	290
Depreciation inc Holding gains	74	163	130	89	111	116
EBIT	**272**	**176**	**187**	**176**	**180**	**175**
ROCE%	17%	11%	13%	14%	12%	12%
Mean Capital Employed	**1,585**	**1,537**	**1,433**	**1,241**	**1,461**	**1,459**
Volumes	**5,853**	**5,814**	**5,261**	**4,391**	**4,995**	**4,900**

Table 7.4: Unit WLR Business Operating costs and depreciation

	2007/08 £	2008/09 £	2009/10 £	2010/11 £	2011/12 £	2012/13 £
Revenue	**110.32**	**110.21**	**110.00**	**110.00**	**110.00**	**110.00**
Pay	15.85	16.32	15.02	14.32	15.30	15.27
Line card and Tams	10.93	11.19	11.77	12.36	12.93	11.95
Accommodation	8.53	8.74	8.42	8.72	9.10	9.35
Stores, contractors, Service centre etc	4.45	4.30	4.08	4.06	4.05	3.88
Corporate Overheads	3.20	3.27	3.07	2.88	3.01	2.99
IT (ex depn)	4.34	4.49	4.11	3.88	4.04	4.02
Fleet	3.06	3.10	2.87	2.91	2.91	2.73
Other	0.81	0.45	0.46	0.48	0.46	0.53
Operating Cost	**51.17**	**51.86**	**49.79**	**49.61**	**51.80**	**50.73**
EBITDA	59.15	58.35	60.21	60.39	58.20	59.27
Depreciation inc Holding gains	12.72	28.12	24.65	20.29	22.24	23.61
Operating Cost inc depn	63.89	79.98	74.45	69.90	74.03	74.34

Review of Key Assumptions

7.9 In the WLR Consultation, we explained that we considered that the analysis and assumptions set out in the LLU Statement continue to provide an appropriate basis for estimating the cost of providing WLR services. We set out why we considered that we should, as far as possible, have a consistent approach in terms of the underlying cost assumptions. We explained that, because LLU and WLR products are competitive substitutes and share a broad range of common costs, it is important that

costs should be calculated on a consistent basis to avoid competition distortion. Specifically, we explained that calculating costs on a consistent basis helps to ensure that the price differentials are not driven by changes in approach or underlying assumptions.

7.10 We also explained in the WLR Consultation that, while we would consider changes impacting on any underlying assumptions prior to the final establishment of the WLR charge, we would only modify the assumptions in the underlying model to the extent that such modification are appropriate and required to ensure a robust outcome for the control. Further, given that we are now setting a shorter control period, we consider that the case for different assumptions needs to be compelling. Our proposal to maintain a consistent approach to the calculation of the WLR charge was accepted by respondents to the WLR Consultation.

7.11 In light of responses to the WLR Consultation, we have reconsidered whether we should update the assumptions in determining the costs of providing WLR. We have concluded that the assumptions set out in the WLR Consultation continue to provide the most appropriate set of assumptions on which to base the cost estimates for WLR and allow WLR charges to be set on a consistent basis with WLR charges. While, we recognise that there may be an argument for some change to some of the assumptions, we consider that overall the assumptions set out in the WLR Consultation continue to be an appropriate basis for modelling costs.

7.12 Set out below are a list of the assumptions used in the modelling of the WLR (and LLU charges) and our assessment of the impact of any recent factors influencing those assumptions.

Table 7.5: Key assumptions

Parameter	Assumption in July	Impact of recent news
Aggregate Volumes	Demand for fixed lines to fall by 7% by 2012/13.	No change to long term forecasts
Change in mix- internal demand for MPF	Internal demand for MPF lines to increase but remain below 0.5m lines	No change to long term forecasts
Change in mix- external demand for MPF	External demand for MPF lines to increase to around 5m lines by 2012/13	No change to long term forecasts
Change in mix – other	Total demand for SMPF to fall to around 11m lines by 2012/13	No change to long term forecasts
Inflation	Annual inflation to be 0% between 2008/09 and 2009/10 then 2.5% thereafter. Specific adjustments to costs – such as reduced Cumulo rates – should also be taken into account.	General inflation assumptions may now be towards low end of a reasonable range.

Pay costs	Long term average real wage inflation of 1% pa	Original assumption may now be at high end of reasonable range in the short term but impact is small given offsetting effect of holding gains
Pension costs – deficit	Regulated charges will not include any contribution to the funding of the pension deficit. However, our long term approach to the funding of pension deficits should be considered in a separate consultation	No change
Pension costs – future costs	Annual charges to meet future liabilities should be included in our assessment of recoverable costs and recent cost-reduction plans should be taken into account	No change
Energy costs	Actual costs based on forward looking contracts effected prior to 2009/10 should be recovered before returning to a long term view.	Future prices for oil now higher than they were earlier this year
Commodity prices	Assets are valued by reference to the cost of replacing the asset at March 2009 prices	Copper prices have risen since March 2009
Scope for efficiency gains	Efficiency gains of 4% in 2009/10 (excluding fault rates) on compressible costs, 3% in 2010/11 and 2% thereafter.	No change
Reduction in fault rates	Fault rates to fall by 2% each year	No change
Cost allocation	Costs of £88m should be reallocated away from the Core Rental Services	No change
Group Costs	Other than the specific exceptions noted elsewhere, no adjustment to Group costs is necessary	No change
IS costs	No adjustment to Openreach’s estimate of IS costs	No change
Line cards	Openreach’s estimate of costs per line appears reasonable.	No change
SLG payments	Openreach should recover efficiently incurred costs.	No change
Light User Scheme	None of the cost of the LUS should be recovered through the regulated services, including administration costs	No change

Regulatory Asset Value ("RAV")	Openreach's assessment of the RAV adjustment appears reasonable	No change
Dropwire costs	To be consistent with our previous approach, a proportion of capital costs relating to residential dropwires installed between 2000/01 and 2004/05 should be excluded	No change
Line length adjustment	Openreach's approach provides a reasonable basis for determining the line length adjustment. No further adjustment is proposed	No change
Cost of capital	The cost of capital was determined on the basis of market information	Recent moves in corporate debt market more likely to support a small decrease than an increase – but not significant

7.13 These assumptions were discussed in detail during the LLU Statement (and the First and Second Consultations and were informed by stakeholder responses to those consultations) and are relied on in this Statement. The reasons for these assumptions are not repeated here other than in the context of any additional information provided by respondents in light of the WLR Consultation.

Volumes

7.14 Our cost forecasts in the WLR Consultation were based on the volume forecasts set out in Annex 7 of the LLU Statement. These assumptions were informed by the responses to the Second Consultation. Only one respondent (SSE) to the WLR Consultation was concerned about the volume figures used.

7.15 We have seen no compelling evidence to indicate that the long term volume projections used in our modelling are likely to be materially misstated. The recent Ofcom publication, The Communications Market Report 2009, confirmed that the key trend assumptions on demand still appear sound.

General Inflation

7.16 To forecast costs, it is necessary to take a view on the extent to which input costs will increase in the future. We explained in the LLU Statement that historically we have used RPI as a reasonable basis for forecasting cost inflation. We noted that, while there is unlikely to be a perfect correlation between the general rate of inflation – as indicated by RPI – and a company's actual rate of inflation, it has nevertheless been considered to provide a reasonable proxy in the past.

7.17 However, we explained that, while the use of RPI as the basis for forecasting cost inflation may remain valid in the longer term, it may be less appropriate in the short term as the cost movements taken into account to determine RPI do not currently provide an appropriate proxy for short term movements in Openreach's costs. Specifically, the current RPI inflation statistic is depressed by two factors which do not have any direct impact on Openreach's costs: the significant recent falls in

mortgage interest and the VAT reduction in December 2008. Openreach's input cost inflation will therefore be higher than RPI inflation next year.

7.18 We therefore estimated the appropriate rate of inflation to be applied to Openreach's costs. We explained that this was difficult to do with certainty. In its May 2009 inflation report, the Bank of England noted that the outlook for inflation remained extremely uncertain.

7.19 This uncertainty has continued. In its August 2009 inflation report, the Bank of England stated that inflation is likely to be unusually volatile in coming months.

7.20 As set out in the LLU Statement our assumption was informed by forecast data collated by HM Treasury and the CBI. New forecasts have since been issued. The movement in these forecasts illustrates the difficulty in forecasting inflation at this time. However, while the latest forecasts indicate that the consensus long term view is that inflation will be slightly higher than was expected a few months ago, they do not provide a compelling case to revise our underlying inflation assumptions.

HM Treasury	**2009 May 09 forecast**	**2009 Aug 09 forecast**	**2010 May 09 forecast**	**2010 Aug 09 forecast**
RPI	-1.6%	-1.2%	2.4%	2.7%
RPIX	0.5%	1.0%	1.9%	1.9%
CPI	0.7%	1.1%	1.6%	1.7%

Source: HM Treasury Forecasts for the UK Economy, April 2009, August 2009

CBI	**2009 Apr 09 forecast**	**2009 June 09 forecast**	**2009 Sept 09 forecast**	**2010 Apr 09 forecast**	**2010 June 09 forecast**	**2010 Sept 09 forecast**
RPI	-0.9%	-1.2%	-0.7%	2.6%	2.1%	3.2%
RPIX	1.1%	1.3%	1.8%	1.9%	1.5%	2.5%
CPI	1.6%	1.9%	2.1%	1.6%	1.6%	1.9%

Source: CBI Economic & Business Forecast, April 2009, June 2009,September 2009

7.21 On this basis, we consider that the rates of inflation assumed for the purpose of the LLU Statement continue to provide an appropriate basis for forecasting Openreach's costs. Specifically, we have assumed a short term rate of 0% in 2009/10, followed by a long term average rate of 2.5% per annum.

7.22 As explained in the LLU Statement, this assumption has been applied to Openreach's costs as follows:

Cost Description	**Rate +1%**	**Rate = 0%/2.5%**	**0%**
Pay			
Current Pay – All	√		
Agency Pay – All	√		
Leavers Payments	√		
Pension Deficit Contribution			√
Labour related			
Stores and Other Opex costs		√	
Fleet		√	
Cost of Sales			
Line Cards and BNS			√

Electronic and Other			√
Accommodation			
Rent		√	
Cumulo rates		√	
Faculties management		√	
Corporate Overheads		√	
IT			
IS Support		√	
IS Development Opex			√
Other income and Operating Costs			
Repayments and Wayleaves			√
Other Operating Income			√
LUS and SLG			√
Capex			
Network Related	√		
Line test and Other			√

7.23 TTG challenged these assumptions in its response to the WLR Consultation on the basis that we had assumed that some charges (for instance pay) will not reflect RPI changes and that we had incorrectly calculated a rate of inflation by including the impact of VAT and mortgage interest cost changes.

7.24 In respect of TTG's first point, we do not accept that the link between pay and RPI would be maintained if it meant that pay would fall in the year (as it would if the latest 2009 forecasts were adopted). On this basis we consider that linking pay inflation to an underlying rate of 0% in the first year – and an average of 1.9% over four years- remains reasonable.

7.25 In respect of the second point, informed by TTG's appeal against the MPF prices but not evident from its response to the WLR Consultation, it appears that TTG considers that our inflation assumptions in years 2 to 4 should be reduced by a combined 1.5% to reflect the unwinding of the upwards adjustment by that amount in year 1. On this basis, TTG appear to arguing for an average inflation rate of around 1.5% per annum over 4 years compared to our assumed average of 1.9%. In light of the apparent upwards trend in expectations for inflation (and the prevailing uncertainty around inflation forecasts at present), we do not consider it appropriate to reduce our inflation assumptions.

7.26 For the purposes of determining the charge control in 2010/11, we must predict the reported level of RPI for October 2009. For the purpose of the MPF prices, we assumed that RPI at October 2009 would be approximately -1.5%, based on the CBI's April report forecasts RPI of -1.9% for the third quarter of 2009 and -0.3% for the fourth. The CBI's June report included revised estimates of -2.0% for Q3 and -0.9% for Q4. The CBI's September report included revised figures of -1.4% for Q3 and 0.0% for Q4. Forecasting a point value for RPI therefore remains difficult. However, consistent with our decision not to change the underlying inflation assumptions in our cost calculations, we have not revised the estimated figure for RPI in the WLR charge control calculation.

Specific rates of inflation

7.27 We have also reconsidered the appropriate assumptions relating to real wage inflation and commodity prices.

Real wage inflation

7.28 In estimating the MPF and WLR costs, we assumed average annual real wage inflation of 1%. As explained in the LLU Statement, although pay costs represent around a third of Openreach's operating costs, the net impact on cost stacks is reduced via the impact of pay costs on the value of the asset base.

7.29 Pay inflation flows into the calculation of holding gains, which – in light of the mix of pay and non-pay costs reflected in the asset base – have been calculated based on the average of pay and non-pay inflation rates.

7.30 Therefore, inflation on pay also increases holding gains (which in turn reduces unit costs). As explained in the LLU Statement, pay inflation affects a larger number via holding gains than via its operating costs. Overall, the impact of the pay inflation assumption on the WLR costs is therefore small.

7.31 There might be an argument to support a lower real pay inflation assumption in the first year of the cost calculations, if we were considering this adjustment in isolation. However, in light of long term trends (and our decision not to increase the general inflation assumption), the case to reduce the assumption in later year is not clear. The impact on operating costs of such a change would in any event be offset by the impact on holding gains.

Copper prices

7.32 We explained in the WLR Consultation that we considered that the opening asset values should reflect recent information. For the purpose of the cost modelling used to derive the MPF and WLR charges, we explained that we considered that a valuation based on the most recent balance sheet date – in this case 31 March 2009 – provides an appropriate (and least arbitrary) point. Taking account of the change in copper prices (in sterling) and information provided by copper cable suppliers and Openreach, we estimated that the value of the copper element of Openreach's assets was around 30% lower than the value reflected in the calculations in the Second Consultation (which anticipated a 3.5% increase in the year, rather than the reduction that actually occurred).

7.33 We explained that the impact of the fall in copper prices to 31 March 2009 was to reduce the MCE associated with an MPF line by around 7%.

7.34 Since 31 March 2009, the cost of copper based on updated information provided by copper cable suppliers has risen by around 35%. If this price rise was taken into account, we estimate that it could add around £2 to the cost stack of each line, through higher annual depreciation and ROCE.

7.35 However, we consider that the justification for taking the valuation as at the balance sheet date rather than at a more recent date continues to apply. Asset prices continue to be highly variable and we consider that to avoid arbitrary use of such data we should remain with the accounting principle behind the cost model we used, that is to remain with the year end valuation principle.

Energy prices

7.36 We explained in the LLU Statement that energy costs represent a significant proportion of Openreach's costs and are subject to unique price pressures.

7.37 We explained that costs incurred under forward contracts could be taken into account. However, informed by responses to the Second Consultation and forward price information, we were not persuaded by Openreach's justification for a 50% increase and estimated that energy costs will increase by 40% in 2009/10 before returning to a level consistent with the 2008/09 costs increased in line with the general inflation assumption.

7.38 CBI forecasts indicate that expectations for oil prices in 2009 and 2010 are now higher than they were a few months ago. However, the impact of any price rises will be reduced because 2009/10 costs are linked to forward contract prices.

Cumulo rates

7.39 We explained in the LLU Statement that BT received a rebate due to the fall in the number of copper lines. We explained that, while BT was considering the impacts of the announcement, it provided us with a breakdown of its 2009/10 Cumulo rates adjustment, split between the impact of higher LLU demand and government rebate. On this basis we reduced the Cumulo rates allocated to the Core Rental Services by £19million.

7.40 We understand future payment levels are still uncertain. There is therefore no compelling case to revise this assumption.

Scope for efficiency gains and fault rates

7.41 In the Second Consultation, we set out our view that Openreach should be able to deliver annual efficiency gains of between 2% and 4% of the costs that can be controlled by Openreach or BT Group (which we described as "compressible costs"). As set out in the LLU Statement, we concluded that the 4% gains likely to be delivered in 2008/09 provide a good indication of the gains that might be achieved going forward. We have not seen compelling evidence that the recent gains can be exceeded on an ongoing basis and accept Openreach's arguments that some of the quick wins achieved in the past may not be replicable; however, we have not been convinced that future gains will tail off as quickly as Openreach suggest.

7.42 On the basis of the analysis set out in the LLU Statement, including the detailed responses to the Second Consultation, we concluded that the following efficiency targets (applied to compressible costs) were reasonable:

	2009/10	2010/11	2011/12	2012/13
General efficiency gain (on compressible costs)	4.0%	3.0%	2.0%	2.0%

7.43 In addition we assumed that Openreach could reduce fault rate by 2% each year. No new information received in response to the WLR Consultation has caused us to revise this view.

7.44 The effective rate of efficiency gain projected by Ofcom for the provision of WLR therefore includes the effects of both the general efficiency assumption plus the

effects of reducing fault rates. The impact of a 2% fault rate reduction is similar to that of a 0.7% general efficiency gain. Including the effects of both, we estimate that the equivalent efficiency rate across compressible costs is as set out in the table below, together with an estimate of the equivalent rate if applied across all operating costs relating to WLR.

	2009/10	2010/11	2011/12	2012/13
Aggregate Efficiency gain (on compressible costs)	4.7%	3.7%	2.7%	2.7%
Equivalent Rate (on all WLR operating costs)	3.0%	2.4%	1.8%	1.8%

7.45 We have considered whether recent events should cause us to revise our efficiency and fault rate assumptions. Sky and TTG have repeated their assertions they made in their responses to the LLU Consultations that the scope for efficiency gains is understated and disputed the relevance of non-compressible costs. These issues were dealt with in the LLU Statement and respondents have not provided additional evidence to cause us to change our assessment set out in that Statement.

7.46 On 8 September, members of the Communication Workers Union (CWU) rejected Openreach's attendance pattern proposals. The CWU is now in talks with Openreach management. We consider that arguments for more aggressive efficiency targets must be considered in light of execution risks which may result.

Cost allocation/ group costs

7.47 We explained in the WLR Consultation that we have undertaken a detailed review of the underlying costs for the copper based services provided by Openreach. This included cost allocations between services and the determinations of key assumptions on future asset prices, appropriate cost of capital and cost allocations to Openreach from other parts of BT (e.g. BT Group).

7.48 In its response to the WLR Consultation, TTG re-iterated points made in its response to the Second Consultation; that we did not address BT's use of biased allocation methods for allocating group costs, that we did not reduce the allocation to properly reflect Openreach's independent and non retail nature, the we did not correct the non allocation of costs to BT's overseas activities or adjust the allocation to reflect Openreach's reducing share of BT Group activity. Sky in its response stated that the 'significant efficiency gains' BT is making Group wide do not appear to have been incorporated into group overhead costs.

7.49 As explained in the WLR Consultation, we recognise that that there will always be alternative methods of allocating costs from BT Group to the lines of business. Inevitably, some of these will result in lower levels of costs being allocated to Openreach, while others would allocate higher costs. We considered a range of potential allocation bases. We concluded that, where sensible alternative allocation bases exist, they would have only a small effect on the total costs allocated to Openreach.

7.50 Taking this analysis into account - alongside KPMG's findings in the 'Review of Openreach Allocation Methodologies' report which informed our decision and concluded "the allocation of costs from BT Group to Openreach (are) reasonable" - we do not consider that any alternative methodology for allocating costs to Openreach is obviously superior to the methodology used by BT.

7.51 In terms of the 'incorrect' allocation of costs to overseas activities, the allocation methodology used in the LLU Statement is generally consistent with that used in preparing the Regulatory Financial Statements. The allocation basis is set out in BT's Detailed Attribution Methodology. The annual audit opinion on the Regulatory Financial Statements provides assurance that the DAM is consistent with the principles set out in BT's Primary Accounting documents and, therefore, comfort that the allocation bases in the DAM are reasonable.

7.52 Further, we have not seen any compelling reasons to depart from the assumption that Openreach will continue to take a constant proportion of BT Group costs – either to increase or decrease the proportion – for the purposes of our modelling of costs in years beyond 2009/10. TTG has collated analysis from various broker reports which indicates that Openreach's revenues might fall between 0.2% and 3.1% relative to the rest of the BT Group. Given the relatively small relative reduction and the fact that costs are not generally allocated on the basis of revenue we do not consider this provides a compelling case to change the basis of allocation.

7.53 In response to Sky's point, our efficiency assumptions were applied to the BT Group overheads allocated to Openreach (except accommodation, cumulo rates, LUS, phonebooks and SLGs, which we considered separately).

Line cards

7.54 We explained in the WLR Consultation that Openreach initially estimated the line card cost to be recovered via the WLR charge on the basis of the number of services provided.

7.55 On this basis, WLR and internal SMPF would both be treated as one service each and internal MPF would be treated as two services (i.e. Voice and Broadband). The result is that that the combi card cost is divided by the total number of services forecast.

7.56 We explained that we considered that this approach resulted in a reasonable unit cost for line cards that includes both legacy PSTN and voice-related costs relating to BT's next generation network (known "21CN"). In particular, we did not consider that it would be appropriate for there to be an increase in the line card costs as a result of using 21CN technology.

7.57 As explained in the WLR Consultation, BT subsequently suspended its plans for the roll-out of 21CN and the current network will continue for the duration of the control.

7.58 However, determining what the cost of continuing with PSTN line cards might be in the future is not straightforward. The cards are no longer manufactured. This makes this approach difficult to implement.

7.59 Whilst potentially there could be cost savings by not installing combi cards, PSTN line cards are reaching the end of their life and must be replaced or refurbished. Delaying replacement past their useful life or refurbishing will result in higher maintenance costs which could increase overall costs.

7.60 It is not clear that there is a more reliable, practicable basis for determining line card costs for WLR than the basis described in the Second Consultation. While the underlying justification has changed, we believe that the unit costs calculations continue to look reasonable.

Cost of capital

7.61 Capital markets are dynamic, and there have been market movements since we finalised our estimate of Openreach's cost of capital for the LLU Statement.

7.62 However, while such movements might have an impact on the individual parameters of the cost of capital estimate, we do not consider that they are sufficiently material to alter our estimate of the cost of capital for the purposes of this charge determination.

7.63 We have therefore assumed that the cost of capital should be 10.1% (and 7.6% in 2009/10, to take account of the lower rate of inflation).

Estimating the cost of the core WLR service

7.64 For the reasons given above, we consider that the WLR cost stacks set out in the WLR Consultation continue to provide an appropriate starting point for our assessment of the costs of the residential and business WLR services.

7.65 However, as set out in Section 3, the two WLR services will be replaced with a single service available to all customers with a specified level of service. Customers would then be able to specify enhanced levels of service at additional cost. It is therefore necessary to calculate the cost of the single service. The aggregate total costs and revenues for WLR and units costs are set out below in 7.6 and 7.7.

Table 7.6: CCA costs and revenues for WLR rentals, assuming prices remain fixed in nominal terms before adjustment for enhanced service costs

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	£'m	£'m	£'m	£'m	£'m	£'m
Revenue	**2,420**	**2,329**	**2,209**	**2,082**	**1,930**	**1,806**
Pay	403	404	350	317	310	289
Line card and Tams	258	257	254	253	244	211
Accommodation	211	210	190	186	179	172
Stores, contractors, SMC and misc.	110	103	92	87	79	71
Corporate Overheads	81	80	71	63	60	56
IT (ex depn)	109	110	95	85	81	75
Fleet	76	75	66	63	58	51
Other	18	9	9	9	8	9
Operating Cost	**1,266**	**1,250**	**1,127**	**1,062**	**1,020**	**934**
EBITDA	1,154	1,079	1,082	1,020	911	872
Depreciation inc Holding gains	235	601	493	377	390	393
EBIT	**918**	**478**	**590**	**643**	**521**	**479**
ROCE%	14%	8%	10%	11%	9%	9%
Mean Capital Employed	**6,629**	**6,298**	**6,103**	**5,992**	**5,708**	**5,428**
Volumes	**23,449**	**22,821**	**21,457**	**20,271**	**18,710**	**17,485**

Table 7.7: Unit WLR Operating costs and depreciation before adjustment for enhanced service costs

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	£	£	£	£	£	£
Revenue	**103.20**	**102.05**	**102.97**	**102.70**	**103.17**	**103.29**
Pay	17.20	17.71	16.32	15.62	16.59	16.55
Line card and Tams	11.01	11.28	11.86	12.46	13.02	12.04
Accommodation	8.98	9.21	8.86	9.20	9.57	9.82
Stores, contractors, SMC and misc.	4.68	4.52	4.29	4.28	4.25	4.07
Corporate Overheads	3.44	3.53	3.31	3.11	3.23	3.21
IT (ex depn)	4.66	4.82	4.41	4.17	4.33	4.30
Fleet	3.25	3.30	3.06	3.10	3.09	2.91
Other	0.79	0.40	0.42	0.44	0.42	0.49
Operating Cost	**54.01**	**54.77**	**52.53**	**52.39**	**54.49**	**53.40**
EBITDA	49.20	47.27	50.44	50.31	48.67	49.89
Depreciation inc Holding gains	10.03	26.35	22.95	18.59	20.83	22.48
Operating Cost inc depn	64.04	81.12	75.48	70.97	75.32	75.88
EBIT	**39.17**	**20.93**	**27.48**	**31.72**	**27.85**	**27.41**
ROCE%	14%	8%	10%	11%	9%	9%
Mean Capital Employed	**282.7**	**276.0**	**284.4**	**295.6**	**305.1**	**310.4**
Volumes	**23,449**	**22,821**	**21,457**	**20,271**	**18,710**	**17,485**

7.66 After including a reasonable rate of return, based on a cost of capital of 10.1% (or 7.6% in 2009/10), the aggregate unit cost for *WLR Basic* and *WLR Premium* would be as set out in table 7.8.

Table 7.8: Unit cost of WLR rental, before adjustment for enhanced service costs

	2007/08 £	2008/09 £	2009/10 £	2010/11 £	2011/12 £	2012/13 £
Operating unit cost	64.04	81.12	75.48	70.97	75.32	75.88
ROCE unit cost	28.55	27.87	21.62	29.85	30.81	31.35
Total unit cost	92.59	108.99	97.10	100.83	106.14	107.24

Estimating the cost of the enhanced service

7.67 To determine the appropriate charge for a core WLR service we determined the aggregate costs for *WLR Basic* and *WLR Premium* and then identified *WLR Premium* specific cost which should be removed.

7.68 As enhanced care services are already provided by Openreach the associated costs are already reflected in the cost stacks set out above. It is therefore necessary to deduct these costs to leave the underlying cost of providing the basic service.

7.69 In the WLR Consultation, we considered three possible approaches to estimating the cost of providing *WLR Premium*. We proposed that we should follow the "incremental savings" approach as it could be readily reconciled with existing activity and was straightforward, as it started from the aggregate WLR cost stack. It was therefore the most practical approach given the LLU Statement methodology.

7.70 Using the 'incremental savings' approach, we estimated the costs that would be saved if the current service levels were reduced back to the level to be provided with *WLR Basic*.

7.71 Additionally we concluded that the 'incremental savings' approach should also assume some additional common costs were recovered from *WLR Premium*. This meant that in addition to the incremental cost of providing the higher service levels, the approach included a share of Openreach's overheads.

7.72 We asked Openreach to provide an estimate of the costs that could be avoided if the enhanced levels of service were no longer provided. These estimates were adjusted to make them consistent with the LLU Statement.

7.73 The two incremental cost savings that Openreach provided information on were Jeopardy Management and Faster Contractual Repair.

7.74 Jeopardy Management is the labour activity carried out to improve provision and repair performance. Openreach argued that Jeopardy management is focussed on more complex jobs, where an engineering visit is required. *WLR Premium* new provides usually require an engineering visit and *WLR Premium* repairs are 'more likely' to require a visit. Openreach consider a 70:30 split of Jeopardy Management activity between *WLR Premium* and *WLR Basic* appropriate.

7.75 Based on the Openreach Pricing Framework Review, Openreach identified Jeopardy management costs of £19.5m. Openreach assumed 70% of Jeopardy management costs were attributed to the premium product. If *WLR Premium* had the same cost characteristics of *WLR Basic*, then these costs would fall by £0.9m to £18.7m. The result average difference of 4p a line.

7.76 Faster contractual repair is the cost of serving WLR Business customers in priority to WLR Residential customers even where it causes inefficiency – e.g. an Engineer's route would be scheduled to attend WLR Business customer in priority to Residential customers even where it might impose additional travelling distances. Openreach have provided evidence that showed removing the need to carry out faster contractual repairs reduced the aggregate repair cost on residential lines by 3.2%. This is equated to a £10m saving.

7.77 In the WLR Consultation we agreed that the costs of faster response times were a legitimate cost differential. The resultant 47p average difference was comparable to the 53p differential in service cost we identified when we set the current Charge Control.

7.78 The approach of including some common costs in the additional costs of *WLR Premium* is consistent with the fully allocated cost approach taken to determining the costs of the rental services in the LLU Statement.

7.79 The LLU Statement did not identify the incremental cost of providing the Premium Product. We could therefore not identify the common costs to be included within the fully allocated cost. This made it difficult to determine how much common cost should be included.

7.80 On the assumption that there is reasonably strong demand for the *WLR Premium* services, users of *WLR Premium* would be more likely be prepared to pay more than the incremental costs to receive these services. We considered it might be a more efficient way of recovering common costs to recover more from *WLR Premium* and correspondingly less from the core WLR service. This seemed likely given the differentials in charges that exit currently.

7.81 In considering the appropriate amount of common cost to include, we took as a starting point the fully allocated cost methodology used in the LLU Statement. In the WLR Consultation we identified that one of the main drivers for the allocation of common costs is labour cost.

7.82 The incremental cost of for faster contractual repair is a labour cost. We assumed that the proportion of common cost included for *WLR Premium* was the same as a proportion of labour as with *WLR Basic* rental. On this basis the 47p saving (as explained above) was mostly labour related, then we estimated that the additional common cost included would be 40p (compared to the average WLR charge).This assumed the incremental labour savings on *WLR Premium* attracted common cost in the same proportion as overall labour on WLR rentals. We estimated the unit cost saving to *WLR Basic* of removing the elements relating to the provision of the premium product were:

	Difference
	£
Jeopardy Management	0.04
Faster Contractual Repair	0.47
Overhead Allocation	0.40
	0.91

7.83 Whilst this resulted in a relatively modest reduction in the aggregate *WLR charge*, we think that it is appropriate to be cautious about recovering additional common costs through *WLR Premium*. This is because we believe that that the level of the *WLR Premium* charge would be constrained by the cheaper *WLR Basic*. In the WLR Consultation we noted that the extent of such substitution was likely to be enhanced in the future because we proposed to ensure that *WLR Basic* was suitable as a base product for business customers. In particular, we stated that we wished to ensure customers are able to buy the product freely and obtain inclusion in business directories. We conclude therefore that the relatively modest differential resulting from the calculation set out in the WLR Consultation is appropriate.

Core WLR Costs

7.84 Based on the approach set out in the WLR Consultation, the cost differential between the average WLR charge and the *WLR Premium* equates to a £0.91p reduction from the aggregate WLR charge. We have assumed the deduction is to operational cost and inflates with general inflation. On this basis we determined the aggregate cost stacks in the WLR Consultation which remain valid as set out in table 7.8.

Table 7.9: Unit cost of aggregate WLR rental, after adjustment for enhanced service

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	74.57	70.04	74.37	74.90
ROCE unit cost	21.62	29.85	30.81	31.35
Total unit cost	96.19	99.89	105.18	106.26

Cost of transfer above the proposed charge

7.85 As set out in the WLR Consultation, we proposed, for pricing purposes only, one further adjustment to the cost stacks that would form the basis for the charges. Specifically, we proposed that, the WLR transfer charge should not be based on the full CCA FAC. Accordingly, we proposed that the costs not covered by the transfer charge are recovered through the rental charge. We therefore included in the WLR rental charge a cost 'transfer' from Transfers to the core WLR service for those costs not covered by the regulated charge. Given average churn rates, this suggested the cost transfer should be split over five years. This therefore increases the core WLR cost.

7.86 In its response, TTG Group felt that such an approach could have unintended consequences if volume forecasts were inaccurate and if it distorted behaviour by

encouraging an inefficiently high level of switching. In addition, they felt this was an administratively complex approach which also resulted in a misleading picture of profitability in the Regulatory financial Statements.

7.87 We agree that inaccurate volumes forecast can result in over or under recovery of costs. This is an issue we face across all aspects of Charge Control setting which we minimise by using the best volume forecasts available to us and seeking comments from Stakeholders through the consultation process. We agree that the adjustment introduces a disconnect into the Regulatory Financial Statements and adds a layer of complexity to price setting. However, we disagree with TTG Group that these downsides are not justifiable in ensuring switching costs at the retail do not discourage competition. Whilst Openreach forecast the continued growth of MPF, by 2012/13 there will still be 4.4m external WLR lines compared to 5m external MPF lines (see table A7.1 in the LLU Statement). The implication is that WLR will still be a very important product to CPs and we need to ensure there are no barriers to switching. We have been provided with no evidence that the current policy of transferring costs to WLR rentals has encouraged inefficient switching behaviour.

7.88 In the WLR Consultation we set out three of ways to calculate the cost transfer. The differences between the methodologies was not great (<£1m) and we proposed using the simplest methodology which assumed the 2012/13 under-recovery of Transfer Charges represented a steady state position. On the basis that revenues were required to equal cost, the transfer of costs to *WLR Basic* rental (assumed to be Opex) equalled £29m for 2012/13. This cost was also transferred in 2009/10 to 2011/12. This adds around £1.35 per line in 2009/10 rising to £1.65 in 2012/13. Adding to the costs in table 7.9 the impact on the *WLR Basic* rental cost stack is set out in Table 7.10.

Table 7.10: Unit cost of WLR core rental, after adjustment for enhanced service costs and cost transfer (for pricing purposes) from WLR transfer

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	75.92	71.47	75.92	76.56
ROCE unit cost	21.62	29.85	30.81	31.35
	97.54	101.32	106.73	107.91

7.89 Table 7.11 sets out the cumulative impact as on the WLR rental charges of the adjustments for enhanced care and the recovery of transfer costs.

Table 7.11: Evolution of the Final Core WLR Rental Charge

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
FAC cost (table 7.8)	97.10	100.83	106.14	107.24
Reduction for enhanced care	(0.91)	(0.94)	(0.96)	(0.98)
Increase for transfer cost	1.35	1.46	1.55	1.65
	97.54	101.32	106.73	107.91

WLR Connections and Transfers

7.90 Set out below in table 7.12 to 7.13 are the aggregate cost stacks for WLR Connections and Transfers (for residential and business lines) and their related unit costs.

Table 7.12: Ancillary services – WLR Connections – Aggregate costs

	2009/10	2010/11	2011/12	2012/13
	£'m	£'m	£'m	£'m
Revenue	110	101	62	39
Operating Cost	41	37	22	14
EBITDA	69	64	40	26
Depreciation	3	4	4	3
EBIT	66	60	36	23
ROCE (%)	368%	305%	257%	253%
Mean Capital Employed	**18**	**20**	**14**	**9**

Table 7.13 Ancillary Services – WLR Transfers – Aggregate costs (before cost transfer)

	2009/10	2010/11	2011/12	2012/13
	£'m	£'m	£'m	£'m
Revenue	9	6	6	6
Operating Cost	27	20	19	18
EBITDA	-18	-14	-13	-13
Depreciation	9	9	13	14
EBIT	-27	-23	-26	-27
ROCE (%)	-54%	-50%	-51%	-54%
Mean Capital Employed	**50**	**45**	**51**	**50**

Table 7.14: Ancillary services – WLR Connections – unit costs

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	35.25	35.49	36.77	36.01
ROCE unit cost	1.09	1.74	2.01	2.08
Total unit cost	36.34	37.23	38.78	38.09

Table 7.15: Ancillary services – WLR Transfers – unit costs (before cost transfer)

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	8.05	9.02	10.75	11.62
ROCE unit cost	0.85	1.43	1.73	1.82
Total unit cost	8.91	10.45	12.48	13.44

Section 8

Conclusions

Introduction

8.1 The earlier sections of this document set out our decisions on restructuring the charge controls for WLR and the cost evidence supporting the development of the charges for the new core WLR rental service and some of the related services. Our decisions were informed by responses to the WLR Consultation. We have taken account of these responses in determining the appropriate assumptions made in our cost calculations.

8.2 Our decisions are also informed by the need to ensure consistency between WLR and LLU charges and are based on the model developed in the Openreach Pricing Framework review and set out in the LLU Statement.

8.3 This section also sets out our proposals for the additional consultation on implementation of the core service and cost orientation on the higher care services.

Prices should move towards the underlying FAC by 2012/13

8.4 As set out in Section 7 our determination of unit costs for core WLR service are as set out in table below.

Table 8.1: Unit cost for recovery by WLR core rental, after adjustment for enhanced service costs and WLR transfer

	2009/10	2010/11	2011/12	2012/13
	£	£	£	£
Operating unit cost	75.92	71.47	75.92	76.56
ROCE unit cost	21.62	29.85	30.81	31.35
Total unit cost	97.54	101.32	106.73	107.91

Prices should move by reference to a glide path

8.5 Having estimate BT's efficient unit costs we now consider whether and if so how to set a glide path to align the charge controls with these cost estimates.

8.6 In general, we consider that there is a strong case for setting charges by reference to a glide path. We consider that glide paths offer stability and predictability and give stronger cost efficiency incentives. Using a glide path for the WLR charge would also be consistent with our usual practice, and therefore give all parties confidence in the predictability of the regulatory regime.

8.7 We also consider that there are advantages to price controls that take account of anticipated movements in the costs of providing the underlying services. The use of an inflation index within a control provides some protection, to both the supplier and the buyer of the services, against changes in the underlying rate of inflation, which, over time, could cause prices, in real terms, to diverge from their intended level.

8.8 Previously, we have linked the control to RPI (in the form of an “RPI- X” adjustment), applied to a starting charge over a number of years. RPI has been used because it is a published, and widely understood, measure of inflation.

8.9 To provide the desired protection against changes in the underlying rate of inflation, the RPI data needs to provide a relevant measure of the cost pressures facing the supplier during the period in which the price control is to apply.

8.10 For practical reasons, the RPI data used in such price controls is historical, published data. As set out in the Second Consultation, for the purposes of applying the indexation in the 2010/11 controls, we are using October 2009 RPI data.

8.11 As we explained in the LLU Statement, while there are limitations to the relevance of RPI data as a measure of the input cost pressure facing BT or Openreach it has generally provided a reasonable basis on which to consider movements in costs. To the extent that it might lead to an inconsistent or distorted measure of inflation in a particular year, the impact of these distortions might be expected to even out over a long control period.

8.12 However, for shorter control periods, any distortion or lag in the RPI data used in setting prices could have implications for the charges set in that year. In this case, we are setting an indexed charge for only one year. For the purpose of setting charges for MPF and SMPF, we therefore considered whether the October 2009 RPI data provided a reasonable basis for the 2010/11control. We concluded that the October 2009 RPI statistic was unlikely to provide a relevant measure of the cost pressures facing Openreach during 2010/11.

8.13 We therefore considered it is appropriate to adjust the glide path for MPF in 2010/11 to allow for the expected bias in the October 2009 RPI data. Because it is not possible to adjust the published RPI statistic to reflect the fact that it does not reflect movements in Openreach’s costs, we adjusted the X.

8.14 We explained that we determined the appropriate glide path for MPF in four stages.

- First we considered what a four-year (real terms) glide path would look like based on our estimate of the 2012/13 costs and the expected rate of RPI inflation over the period.
- Informed by that glide path, we then determined the appropriate starting charge for MPF in 2009/10 giving weight to alternative methods for determining the start charge - including the case for full cost recovery in 2009/10.
- Having established the appropriate starting charge for MPF in 2009/10, we determined the appropriate glide path over the remaining three years, again based on our estimate of the 2012/13 costs and the expected rate of RPI inflation over the remaining period.
- We then defined the X in 2010/11 to reflect the fact that the RPI statistic that will be used in the control does not reflect our assessment of the relevant underlying rate of inflation for the period in question.

8.15 We concluded that, in order to deliver the appropriate real terms increase in 2010/11 we should adjust the X to allow for the expected difference between the reported RPI in October 2009 and the actual RPI for 2010/11. We explained that the difference was significant (approximately 4%).

8.16 As explained in the WLR Consultation, while LLU and WLR are SMP remedies for separate markets, they can be used as alternative inputs in the provision of certain downstream services (ie combined provision of narrowband and broadband). Therefore, in setting the charge control for WLR it is relevant to consider the pricing relationship between WLR, MPF and SMPF to avoid competition distortion.

8.17 As proposed in the WLR Consultation and in line with the response to that consultation, we have therefore set a nominal price for 2009/10 and a control that incorporates an X adjusted on the same basis as for the MPF charge.

Implications for WLR prices

8.18 As set out above, we consider that prices should move towards the underlying FAC by 2012/13. As set out above, we have estimated that the FAC of the WLR core rental service will be around £107.91 in 2012/13.

8.19 A glide path to allow the current price to increase towards FAC by 2012/13 would therefore allow prices to rise upon implementation of the new controls in 2009/10.

8.20 However, this would have the effect of increasing the price in a year when the price is above our estimate of the efficiently incurred cost in the year (£97.54).

8.21 We therefore considered the case for an initial step reduction in the WLR charge. We proposed in the WLR Consultation that, rather than reduce the price half way through 2009/10 then allow it to increase in 2010/11, we would retain the current ceiling for the WLR core rental service at £100.68.

8.22 It is therefore necessary to consider how prices should be allowed to move in 2010/11. With this in mind, we have followed a similar approach to the one we took for MPF in the LLU Statement and summarised above.

8.23 On the same basis, our analysis suggests that a small "true" real terms decrease of around 0.2% per annum in prices is needed to allow the necessary nominal increases in prices in order for prices to move towards full cost recovery by 2012/13.

8.24 However, in order to deliver this real terms decrease in 2010/11 we have adjusted the X to allow for the expected difference between the reported RPI in October 2009 and the actual RPI for 2010/11.

8.25 In the LLU Statement we concluded that the difference was approximately 4%. On the same basis, we consider that an X of 3.8% is appropriate for WLR prices in 2010/11.

8.26 In effect this means that, if inflation is in line with our expectations, the core WLR rental charge will increase by around 2.5% in 2010/11.

Other charges

WLR Transfer

8.27 As discussed in Section 6 we will continue to support competition in exchange lines by maintaining a policy of a low WLR transfer charge.

8.28 We have decided that this will increase from £2 to £3 in the first year with an increase of RPI+3.8 for 2010/11 (the same increase as the core rental charge).

WLR New Connection charge

8.29 We noted earlier the substantial over-recovery of the existing WLR new connection charge. Consistent with the changes to the LLU new line charge we have reduced the WLR new connection charge from £88 to £67 in the first year.

8.30 On a cost basis, in terms of the second year X (adjusted as above for 'exceptional RPI) our calculation showed the X at -15.7%.

8.31 This was based on Openreach forecast volumes which fell dramatically (from 1,149k in 2010/11 to 707k in 2011/12 to 448k in 2012/13).

8.32 We felt given the uncertainty over the volumes at the end of the control there was a risk the dramatic fall in 2012/13 might be overstated. This figure however was the basis of our bottom end range.

8.33 We consider an adjustment fixed the 2012/13 volumes at the same level as 2011/12 (707k). This provided a top end price point and resulted in a second year X of -17.0%. As this seemed out of line with the overall downward trend in WLR volumes, we presented a more narrow range in the consultation reflecting at the upper end a mid-point estimate of volumes between not change and Openreach estimate. Thus, our range was -15% to -16%.

8.34 The uncertainty as to these end-of-control volumes remains. We have therefore decided that our mid-point volume estimate is appropriate supporting a reduction next year of RPI-16%. We consider that this is an appropriate adjustment as this will still provide a charge for new lines above the CCA FAC level, even under Openreach's volume assumptions.

Summary of charge controls

	Current price	**2009/10**	**2010/11**
New WLR Core Rental Service	£100.68	£100.68	RPI +3.8%
WLR transfer charge	£2.00	£3.00	RPI +3.8%
WLR new connection	£88.00	£67.00	RPI-16%

Implementation of the controls

8.35 The new controls will take effect from 23 November 2009, which will allow 28 days notice from the publication of this statement.

8.36 However, we are not requiring BT to provide business directory listings from the time that the control comes into effect. We are consulting on a direction to place a requirement on Openreach to provide business directory listings as part of the WLR Core Rental service from the July 2010 WLR3 1400 release and subsequently only to require such business directory listing to be provided for WLR3 lines.

8.37 We are also consulting on the final removal date for the *WLR Premium* charge ceiling. Our proposal is that this charge ceiling should be removed at the same time as the WLR3 1400 release.

Controls on higher care services

8.38 We are also consulting on our proposal to remove the cost orientation obligation on Openreach with respect to the higher care service package for WLR rental as set out in the Condition in Annex 6. We will continue to monitor Openreach's approach to the pricing of these services.

Conclusions on legal tests

Introduction

8.39 We summarise in Section 2 our statutory duties and legal tests relevant to the decisions and further proposals discussed in this Statement. Our reasoning as to how they are secured and met has been discussed throughout this Statement in relation to each relevant issue. We summarise our views below in light of the conclusions set out above.

8.40 To give regulatory effect to our decisions, we have set a new SMP condition (AAA4(WLR)) and made a modification to an SMP condition (AAA3).

8.41 We are now proposing to set a new SMP condition AAA4(B) to maintain the charge ceiling for the annual rental of a Wholesale Analogue Line Rental (business quality of service) imposed by Ofcom in 2006 by means of a direction under SMP conditions that were revoked by Ofcom in September 2009 in concluding the fixed narrowband market review. Our proposed phased withdrawal of that 2006 direction in our July consultation is therefore no longer required because the direction has ceased to have effect as a result of the revocation of the previous SMP conditions.

8.42 We are also proposing to set two further directions upon which we are consulting. The first direction is to exempt enhanced care services from the basis of charges condition (SMP condition AAA3) applied to the wholesale analogue exchange lines and wholesale ISDN2 exchange lines markets. The second direction is to set the date upon which BT should be required to provide a business directory listing with the analogue core rental product.

8.43 The texts of the legal instruments dealing with the above decisions and proposals are set out in Annex 6 to this Statement as follows:

8.43.1 Part I – Setting of SMP condition AAA4(WLR) and modification to SMP condition AAA3.

8.43.2 Part II – Proposed setting of SMP condition AAA4(B).

8.43.3 Part III – Proposed Direction regarding the removal of the cost orientation obligations for Enhanced Service Level Care under SMP condition AAA3 and AAA10.

8.43.4 Part IV – Proposed Direction regarding an amendment of the definition of Analogue Core WLR Rental for the purpose of SMP condition AAA4(WLR) to include a business style directory listing on the so-called WLR Business Implementation Date.

Part I: Charge control – SMP condition AAA4(WLR)

Aims and Effects

8.44 SMP condition AAA4(WLR) requires Openreach to ensure that its charges for WLR Core Rental, transfer charges and new line provide charges do not exceed a fixed ceiling to 31 March 2010 and then do not increase by more than RPI -/+ X that varies according to each service for the following year to 31 March 2011. The values of X are set out in the condition.

8.45 Ofcom's reasons for imposing this particular form of control and the values of X are summarised above. We have decided that the first period for the control will run from 23 November 2009 to 31 March 2010, with the control period lasting for a further 12 months until 31 March 2011. The control is set on the basis that prices should glide towards towards FAC CCA . In our July consultation we proposed a 3.5 year control, and we have retained the same cost forecast notwithstanding that the control as set, will last for just over 16 months.

8.46 In confirming a shorter duration, we have considered the effect that this will have on the control and specifically the requirements imposed by section 88 of the Act, which we assess in relation to the condition as a whole below.

8.47 The condition contains mechanisms to deal with, by means of directions, any material changes (other than to a charge) made by Openreach to any product or service subject to the charge control.

8.48 We have also drafted the condition to require Openreach to record, maintain and supply data to Ofcom in relation to performing the percentage change calculation. Such data is required to be provided within three months of the end of each control year. It is essential for this information to be supplied *ex ante* to ensure that we can effectively monitor compliance with the controls.

8.49 We have amended our definition for 'Analogue Core WLR Rental' from the proposed definition in our July consultation. We have amended it to add legal clarity and certainty of the three basic elements that we consider are required to be provided as part of this service, namely: line rental, Level 1 service support for *Basic* lines and a directory listing (to start with, residential style only, see below).

8.50 We have also amended the definition so that we can, if required, direct any changes to those three basic elements. We consider that such a mechanism is required in order for us to require BT initially, only to supply a residential directory entry, an obligation that we are proposing to amend to cover business directory entries from July 2010 (i.e. the proposed direction at Part IV of Annex 6 to this Statement).

8.51 We also consider that it is important to ensure that the basic level of service support for the core service remains at an appropriate level. Our proposal to exempt enhanced care services from the basis of charges condition is based, in part, on the ability of customers to switch to the core product. In order for there to be such substitution, the core product must remain appropriately supported. We consider that changing the drafting of the definition to allow a potential change to the definition supports the strength of our arguments and addresses potential concerns raised by stakeholders in responses to our July consultation.

Our duties and policy objectives

8.52 Our opinion of the likely impact of these decisions (as discussed throughout this document) is that the performance of our general and specific duties under sections 3 and 4 of the Act is secured or furthered by the way we have designed the charge control.

8.53 In particular, we consider that the charge control is designed to ensure that charges for WLR services can be set at a level that will enable other CPs to compete in the provision of downstream services. We have had particular regard to the requirement to promote competition and to secure efficient and sustainable competition for the benefit of consumers, which are relevant to both sections 3 and 4 of the Act.

8.54 We have also borne in mind the need to seek the least intrusive regulatory and targeted measures to achieve our policy objectives.

8.55 In addition, we have taken into account further objectives, including:

- Prices – to ensure that retail services are available at prices that are reasonably related to the efficient costs of supply.
- Investment and innovation – to promote efficient investment in the development of new and innovative services by BT, Openreach and other communications providers.

Powers under sections 87 and 88 of the Act

8.56 The Wholesale Review decided that BT held SMP in an identified market, wholesale analogue exchange line services for the UK (except the Hull Area). Section 87(1) of the Act provides that, where Ofcom has made a determination that a person has SMP in an identified services market, they shall set such SMP conditions authorised by that section as they consider it appropriate to apply to that dominant provider.

8.57 Having determined that BT held SMP in the wholesale analogue exchange line services market, Ofcom considered that a number of SMP remedies were needed and appropriate given the market failures identified. These included:

- a requirement to provide network access
- a basis of charges obligation;
- a requirement to provide WLR; and
- charge controls.

8.58 In determining that BT has SMP in the wholesale analogue exchange line services market, we concluded from the market analysis in the Wholesale Review that there was a risk that BT could set excessive prices for services within the market. We therefore concluded that the test in section 88(1)(a) of the Act was satisfied.

8.59 Section 88(1)(b) also requires that the setting of the SMP condition imposing charge controls must appear to Ofcom to be appropriate for the purposes of:

i) promoting efficiency;

ii) promoting sustainable competition; and

iii) conferring the greatest possible benefits on end users.

8.60 We consider that the condition AAA4(WLR) is appropriate for the purposes of promoting efficiency, sustainable competition and conferring the greatest possible benefits on end users.

Promotion of efficiency

8.61 We consider that shorter controls, in general, should ensure that prices have less opportunity to diverge from costs, conversely longer controls tend to have greater dynamic efficiency properties, and greater security and confidence in the market. As we have set out in Section 5 above, we consider that the cost differential between LLU and WLR is a key consideration in the setting of appropriate prices. The responses we received to the July consultation favoured a move to a shorter control from the proposed 3.5 year control.

8.62 We therefore consider that the move to a shorter control remains appropriate for the promotion of efficiency, albeit with a different emphasis following our careful consideration of stakeholder responses. We consider that the construction of the control, using an RPI +/- X formulation so that Openreach is encouraged to achieve greater efficiency in the provision of the controlled services, holds for the shorter period that the control will operate for. This will provide an incentive by allowing Openreach to keep any returns associated with efficiency gains over and above those forecast when the control is set. The benefits of lower costs can then be passed onto customers.

8.63 We recognise that the shorter control period creates weaker incentives for dynamic efficiency than a longer period would. However, we have concluded that, in this case, the dynamic efficiency benefits of a longer control period would be offset by the need to maintain consistency between the charge controls for LLU and WLR.

Sustainable competition

8.64 The charges are set at a level that ensures sustainable competition as they allow the incumbent to make a reasonable level of return whilst ensuring that purchasers of the wholesale products are able to enter the market with a product priced competitively.

8.65 We have in this Statement, and in the associated cost analysis from the LLU Statement, looked at a range of evidence when coming to a view on Openreach's efficiency. We have also had regard to the appropriate cost accounting methodology to be adopted.

8.66 We also consider that a single core control will allow Openreach to offer a variety of services, either as bundled offerings or by way of developing further "value added" services in order to respond to any particular demand in the market, thus allowing greater flexibility and therefore potentially greater choice of service by end users.

8.67 As discussed at paragraphs 8.63 – 8.65 above and in Section 3 of this Statement, we have decided to adopt a shorter period for the control than we consulted on. For the same reasons, and having given careful consideration to the views expressed by stakeholders, we consider that although investment strategy is generally assisted by stable prices created by longer controls, and such strategy can be seen as an important driver for sustainable competition, in this case the stability incentives of a

longer control are less likely to lead to the promotion of sustainable competition than a control that seeks to ensure maximum consistency between LLU and WLR prices.

Greatest possible benefit for end users

8.68 We consider that the control sets prices with reference to cost and, for the reasons described at paragraph 8.66 and in Section 3 of this Statement, they should ensure that fair prices are charged by Openreach for provision of the charge controlled services to other CPs.

8.69 We also consider that a single core control will allow Openreach to offer a variety of services, either as bundled offerings or by way of developing further “value added” services in order to respond to any particular demand in the market, thus allowing greater flexibility and therefore potentially greater choice of service by end users.

8.70 We therefore consider that the tests in section 88(1)(b) are satisfied by the SMP condition that we have imposed. We also consider that, in basing the control on allowing Openreach to recover its costs plus a reasonable return, we have taken into account the investment made by Openreach in accordance with the requirement in section 88(2) of the Act.

The section 47 test

8.71 Ofcom must also be satisfied that SMP condition AAA4 (WLR) satisfies the test in section 47 of the Act, namely that any SMP service condition be objectively justifiable, not unduly discriminatory, proportionate and transparent.

8.72 Our charge control has been structured to deliver the lowest possible charges to competitors for the wholesale services, while ensuring that Openreach is able to recover costs, including a reasonable return on investment.

8.73 The structure of the control is such that BT has an incentive to continue to seek efficiency gains and is able to benefit from efficiencies achieved that are in excess of those anticipated in our review.

8.74 The controls are also objectively justifiable in that the benefits of RPI-X price controls are widely acknowledged as an effective mechanism to reduce prices in a situation where competition does not act to do so.

8.75 Further, our decision to charge control a single core rental service (rather than to maintain separate controls for business and residential services) reflects the analysis undertaken in the Wholesale Review in which we identified a single market for wholesale analogue exchange lines, based upon an analysis of the market and the services currently available within that market. We also consider that the revised definition for the WLR Core Rental service will allow flexibility in providing a minimum standard given the concerns expressed by stakeholders in relation to the pricing of enhanced services. We consider that this modification to our proposal in the July consultation is justifiable on the basis that any such change would have to be made by direction and be justified under section 49 of the Act by reference to the same four criteria as set out in section 47. Further, any proposal to amend the definition by direction would also require to be consulted upon.

8.76 Secondly, the charge controls will not discriminate unduly against a particular person or particular descriptions of persons because any CP (including BT) can access the services at the regulated charges. The controls are designed to ensure fair returns

and price levels for all customer groups. In addition, Ofcom considers that they do not discriminate unduly against Openreach as the controls address BT's dominant position in the relevant market, including its ability and incentive to set excessive charges for services falling within the controls. No persons other than BT and KCom[59] have been determined by Ofcom as having SMP in this services market.

8.77 Thirdly, the charge controls are proportionate because BT's obligations apply to the minimum set of charges required for the delivery of the bottleneck services. In particular, we have decided that only a single core rental service needs to be charge controlled, and that this price can then inform the cost of any other "bundled" services that Openreach may choose to offer, including, for example enhanced care provisions. The charge controls are focused on ensuring that there are reasonable prices for those access services which are critical to the development of a competitive market, whilst allowing a reasonable return on investment. Openreach will also have incentives to continue to invest and develop its access network. Moreover, the maximum charges Openreach is allowed to set over the period of the control has been formulated using information on BT's costs and a consideration of how these costs will change over time.

8.78 We therefore consider that the charge controls would further our policy objectives of ensuring the WLR charges are consistent with LLU charges and that they represent a level which encourages sustainable competition. We consider that the means employed to achieve these aims are both necessary and the least burdensome to address effectively the concerns we have set out.

8.79 Finally, we consider that the charge controls are transparent. Their aims and effect are clear and they have been drafted so as to secure maximum transparency. Their intended operation are also aided by our explanations in this Statement.

Other market analysis considerations

8.80 For the reasons set out above we have concluded that maintaining an appropriate LLU to WLR price differential is an important consideration in the promotion of competition in these markets. We, therefore, consider that setting a short control is an appropriate way to address the identified competition concerns. In setting a control that is designed to end during the course of a market review forward look, we consider that it will be appropriate for us to then consider setting a further appropriate control for the remainder of the review period.

8.81 We have taken into account, in making this decision, the fact that we will be required to comply with section 86 of the Act when setting any new WLR SMP charge control conditions in 2011. Section 86 allows the setting of SMP conditions only after a market review, or where there has been no material change since the last market review. We are not able to predict today what (if any) changes will occur in the market by April 2011. Therefore, we are not able to assess which of the section 86 requirements we will need to satisfy, but we are mindful that this may require a full review of the market. Meanwhile, we consider that the shorter control is the appropriate SMP condition to be applied in the circumstances.

[59] For reasons already set out in the Wholesale Review, Ofcom considers that it would not be proportionate to impose charge controls on KCOM in this market.

Part I: Basis of charges – SMP condition AAA3

8.82 As described above, Ofcom set in the Wholesale Review SMP condition AAA3 requiring that BT's 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. That condition will apply to all services within that market unless it is specifically disapplied.

8.83 In the July consultation, we proposed that SMP condition AA3 (as it was then numbered and described in the Wholesale Review consultation), should be amended to:

- clarify that charge controlled services under the WLR charge control condition should explicitly remain subject to a basis of charges condition; and
- exempt from this obligation core rental charges due to the cost analysis for core rental charges not being wholly based on LRIC+, as we explain below.

8.84 In the Wholesale Review, we adopted the final wording of the basis of charges condition, now SMP condition AAA3. The condition makes it clear that any service subject to a charge control, numbered with an AAA4 prefix, will remain subject to the basis of charges condition. This will include condition AAA4(WLR) which we set within this Statement.

8.85 We have also decided to modify SMP condition AAA3 to ensure that the core rental service is not subject to the basis of charges obligation. The reasoning for this follows the same logic that was applied in 2006, when the WLR charge ceiling direction was made, and continued in our analysis of costs in the LLU Statement, which we have adopted in this Statement. This is because one of our assumptions taken into account in assessing the cost bases relates to the valuation applied to copper network assets. This is known as Regulated Asset Value (RAV) adjustment and has been applied to copper access products (LLU and WLR). Given that BT's pre-1 August 1997 copper access network assets account for a significant proportion of the costs that make up the WLR rental charge ceiling in the first control year (and then followed by indexation of that ceiling in subsequent years), 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 AAA3, as set in the Wholesale Review, which requires charges for Network Access to be 'based' on LRIC+.

8.86 We have made the modification to SMP services condition AAA3 by inserting a paragraph into the condition that clarifies that the services now charge controlled remain subject to the basis of charges requirement, but excluding WLR rental services from that obligation.

8.87 We consider that this modification satisfies the tests in section 47 of the Act as it remains consistent with our approach to the pricing of copper access services taken in previous reviews and in the LLU Statement. The modification is therefore objectively justifiable, proportionate and does not unduly discriminate. Further, its aim and effect is to add legal clarity and certainty to exactly which services are subject to the basis of charges condition and therefore the amended condition is transparent in what it seeks to achieve.

Part II: Proposed charge ceiling – SMP condition AAA4(B)

8.88 The prices for WLR services were previously regulated by fixed price ceilings that were set under a direction (the 2006 direction) made in the statement Wholesale Statement.[60]

8.89 For the reasons discussed, we consider that the current charge ceilings as imposed by the 2006 direction are no longer the appropriate remedy by which WLR prices should be regulated since they cover residential and business WLR separately. Therefore, in our July consultation, we proposed to withdraw the 2006 direction. As already explained, Ofcom has since revoked the previous SMP conditions under which the 2006 direction was given. The requirement to comply with a direction, and the enforceability of such requirement by Ofcom under the processes in the Act, require that the SMP condition in question remains in force.

8.90 We nonetheless consider it necessary and appropriate to maintain the charge ceiling in the 2006 direction to ensure that BT does not charge more than the amount of £110.00 per annum for the annual rental of a Wholesale Analogue Line Rental (business quality of service). We also accept the need to allow Openreach a period of time to implement changes to their systems in order that they can fully offer the new core service.

8.91 As we have explained above, BT can and are obliged to offer the new core service (based on their current *WLR Basic* product) from 23 November 2009. But, until their systems can be upgraded in July 2010, they should not be obliged to offer a business directory listing. This means that the only product that BT will offer prior to July 2010 which comes with a business directory listing as standard will be *WLR Premium*. *WLR Premium*, as a specific product will not be charge controlled by SMP condition AAA4(WLR). We need therefore need to ensure that business users are protected in the period up until July 2010 from Openreach being able to set excessive prices for their Premium product.

8.92 We consider that, in the interim, it would be appropriate to, in effect, continue the 2006 direction by means of the proposed SMP condition AAA4(B), but only in so far as it applies to WLR (business level of service), which maintains a price ceiling of £110 for such services. *WLR Premium* is the Openreach product that is constrained by this ceiling.

8.93 Although two price ceilings will nominally apply to *WLR Premium* in this interim period, we do not consider that they are inconsistent in that the core ceiling of £100.68 applies to the core package (as defined in AAA4(WLR).14), and the £110 ceiling applies to the enhanced *WLR Premium* product that comprises the core package plus business listing and enhanced care package. This is not a case of double jeopardy, rather it being necessary to ensure that business users remain protected from the identified competition concern of potentially excessive pricing.

8.94 Again, we must be satisfied under section 47 of the Act that the withdrawal is objectively justifiable, not unduly discriminatory, proportionate and transparent. We consider, in particular, that SMP condition AAA4(B) is:

[60] http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/

- objectively justifiable 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;
- proportionate as it allows BT a fair rate of return that it would expect in competitive markets;
- not unduly discriminatory to BT because there is no other provider with SMP currently specifically required to provide WLR services; and
- transparent in that the requirements on BT are clearly set out in the face of the condition.

We are also proposing to disapply the basis of charges obligations on BT for the same logic that was applied in 2006, when the WLR charge ceiling direction was set (see also paragraph 8.87 above) as to the impact of the RAV adjustment.

Requiring BT to implement price changes with 28 days notice

8.95 The Wholesale Review has set SMP condition AAA6(a) which requires BT to give notice of amendments to prices in certain circumstances. That provision does not apply to cases where such changes are directed or determined by Ofcom. Therefore, BT is not bound by a requirement to give notice before any initial price changes that they would be required to make in consequence of any final decision by Ofcom in this review. However, we consider that BT should give CPs 28 days' notice when initially amending its prices for WLR services to align with any charges as set out in the Notification.

8.96 We consider that this can be achieved by ensuring that the proposed SMP Condition AAA4(WLR) does not come into effect for at least 28 days after the publication of our final statement and Notification. Accordingly, we have in paragraph AAA4(WLR).1 of that condition set a fixed charge ceiling for a period to run to the start of the first full year of the control (April 2010 – March 2011). As we explained in the July consultation, this period could start, at the earliest, on 1 October 2009, however, the dates were not fixed in our proposals in order to specifically allow for a different period of notice should we publish our Notification less that 28 days before the 1 October 2009. We have now set the commencement dates (rental effective date and ancillary effective date) in AAA4(WLR) as 23 November 2009. We have not set different dates for these services. We have considered the appropriateness of SMP condition AAA4(WLR) in relation to the relevant legal tests above.

Part III: Proposed Direction regarding the removal of the cost orientation obligations for Enhanced Service Level Care under SMP condition AAA3 and AAA10.

8.97 We have set out in Section 4 of this Statement our proposals for removing enhanced care service from SMP condition AAA3, basis of charges and SMP condition AAA10.2 cost orientation.

8.98 We discuss, specifically at paragraphs 4.41 to 4.51 why we consider that the proposed direction satisfies the tests in the Act.

Part IV – Proposed Direction regarding an amendment of the definition of Analogue Core WLR Rental for the purpose SMP condition AAA4(WLR) to include a business style directory listing on the so-called WLR Business Implementation Date

8.99 We have set out above the need to allow BT time to ensure that they can fully upgrade their systems to offer an integrated core rental product to service both residential and business end users.

8.100 SMP condition AAA4(WLR) defines in AAA4(WLR).14(a) 'Analogue Core WLR Rental' as follows:

> "*(a) "Analogue Core WLR Rental" means, unless Ofcom directs otherwise from time to time for the purpose of the meaning of this expression, such services as the Dominant Provider is required to provide under SMP services condition AAA10.1(a) and which on the date this Condition takes effect include:*
>
> *i. the rental of an analogue exchange line for control and billing purposes;*
>
> *ii. maintenance which is part of the service provided by the Dominant Provider in consideration of the charge for an Exchange Line and includes a maintenance service level with a fault repair time of no more than provided for Level 1 service care level for Basic lines, as defined in the Dominant Provider's standard terms and conditions; and*
>
> 8.101 *iii. one residential style main directory listing per telephone number;*"

8.102 BT will therefore be required to only provide one residential style main directory listing to start with. Businesses and similar organisations are not able to be listed in the residential directory.

8.103 BT will be able to offer listings in the business directory once they have rolled out Release 1400 upgrades in July 2010. Once this has occurred, we need to amend the definition in AAA4(WLR).14(a) to reflect this change. As seen above, the condition provides for a direction making power under section 49 of the Act, and therefore we have already proposed a direction to modify this definition in relation to the minimum directory entry requirements.

8.104 Specifically, we propose to require that BT should provide core to include as a minimum:

- the rental of an analogue narrowband access line for control and billing purposes;
- maintenance which is part of the service provided by BT in consideration of the charge for an exchange line and includes a maintenance service level with a fault repair time of no more than provided for Level 1 service care level for *Basic* lines, as defined in BT's standard terms and conditions; and
- one main directory listing per telephone number, comprising of either:
    i. a residential style listing; or

ii. a business style listing, where BT provides to CPs a WLR3 service, as defined in BT's standard terms and conditions.

8.105 We consider that the proposed direction complies with the tests in section 49 of the Act for the reasons set out below.

8.106 The proposed direction is objectively justifiable as it updates a definition in order that the required charge control applied to WLR services operates in relation to both residential and business supply as soon as BT is in a technical position to offer that service. This fulfils the original intent of the charge control.

8.107 It is not unduly discriminatory as it applies the control equally for all customers of WLR rental products.

8.108 It is proportionate as it does not alter any other aspect of the control, and simply extends the regulation to reflect BT's ability to provide a full service, including provision of a business directory listing.

8.109 It is transparent as it seeks to make a clear amendment to the minimum level of supply for the core service. It is clear to both BT and CPs what will be required to be supplied as part of the core service.

Annex 1

Responding to this consultation

How to respond

A1.1 Ofcom invites written views and comments on the issues raised in this document, to be made by **5pm** on **7 December 2009**.

A1.2 Ofcom strongly prefers to receive responses using the online web form at http://www.ofcom.org.uk/consult/condocs/wlr/howtorespond/form, as this helps us to process the responses quickly and efficiently. We would also be grateful if you could assist us by completing a response cover sheet (see Annex 3), to indicate whether or not there are confidentiality issues. This response coversheet is incorporated into the online web form questionnaire.

A1.3 For larger consultation responses - particularly those with supporting charts, tables or other data - please email markham.sivak@ofcom.org.uk attaching your response in Microsoft Word format, together with a consultation response coversheet.

A1.4 Responses may alternatively be posted or faxed to the address below, marked with the title of the consultation.

Markham Sivak
Floor 4
Competition Policy
Riverside House
2A Southwark Bridge Road
London SE1 9HA

Fax: 020 7783 4109

A1.5 Note that we do not need a hard copy in addition to an electronic version. Ofcom will acknowledge receipt of responses if they are submitted using the online web form but not otherwise.

A1.6 It would be helpful if your response could include direct answers to the questions asked in this document, which are listed together at Annex 4. It would also help if you can explain why you hold your views and how Ofcom's proposals would impact on you.

Further information

A1.7 If you want to discuss the issues and questions raised in this consultation, or need advice on the appropriate form of response, please contact Markham Sivak on 020 7783 4659.

Confidentiality

A1.8 We believe it is important for everyone interested in an issue to see the views expressed by consultation respondents. We will therefore usually publish all responses on our website, www.ofcom.org.uk, ideally on receipt. If you think your response should be kept confidential, can you please specify what part or whether

all of your response should be kept confidential, and specify why. Please also place such parts in a separate annex.

A1.9 If someone asks us to keep part or all of a response confidential, we will treat this request seriously and will try to respect this. But sometimes we will need to publish all responses, including those that are marked as confidential, in order to meet legal obligations.

A1.10 Please also note that copyright and all other intellectual property in responses will be assumed to be licensed to Ofcom to use. Ofcom's approach on intellectual property rights is explained further on its website at http://www.ofcom.org.uk/about/accoun/disclaimer/

Next steps

A1.11 Following the end of the consultation period, Ofcom intends to publish a statement early in 2010.

A1.12 Please note that you can register to receive free mail Updates alerting you to the publications of relevant Ofcom documents. For more details please see: http://www.ofcom.org.uk/static/subscribe/select_list.htm

Ofcom's consultation processes

A1.13 Ofcom seeks to ensure that responding to a consultation is easy as possible. For more information please see our consultation principles in Annex 2.

A1.14 If you have any comments or suggestions on how Ofcom conducts its consultations, please call our consultation helpdesk on 020 7981 3003 or e-mail us at consult@ofcom.org.uk . We would particularly welcome thoughts on how Ofcom could more effectively seek the views of those groups or individuals, such as small businesses or particular types of residential consumers, who are less likely to give their opinions through a formal consultation.

A1.15 If you would like to discuss these issues or Ofcom's consultation processes more generally you can alternatively contact Vicki Nash, Director Scotland, who is Ofcom's consultation champion:

Vicki Nash
Ofcom
Sutherland House
149 St. Vincent Street
Glasgow G2 5NW

Tel: 0141 229 7401
Fax: 0141 229 7433

Email vicki.nash@ofcom.org.uk

Annex 2

Ofcom's consultation principles

A2.1 Ofcom has published the following seven principles that it will follow for each public written consultation:

Before the consultation

A2.2 Where possible, we will hold informal talks with people and organisations before announcing a big consultation to find out whether we are thinking in the right direction. If we do not have enough time to do this, we will hold an open meeting to explain our proposals shortly after announcing the consultation.

During the consultation

A2.3 We will be clear about who we are consulting, why, on what questions and for how long.

A2.4 We will make the consultation document as short and simple as possible with a summary of no more than two pages. We will try to make it as easy as possible to give us a written response. If the consultation is complicated, we may provide a shortened Plain English Guide for smaller organisations or individuals who would otherwise not be able to spare the time to share their views.

A2.5 We will consult for up to 10 weeks depending on the potential impact of our proposals.

A2.6 A person within Ofcom will be in charge of making sure we follow our own guidelines and reach out to the largest number of people and organisations interested in the outcome of our decisions. Ofcom's 'Consultation Champion' will also be the main person to contact with views on the way we run our consultations.

A2.7 If we are not able to follow one of these principles, we will explain why.

After the consultation

A2.8 We think it is important for everyone interested in an issue to see the views of others during a consultation. We would usually publish all the responses we have received on our website. In our statement, we will give reasons for our decisions and will give an account of how the views of those concerned helped shape those decisions.

Annex 3

Consultation response cover sheet

A3.1 In the interests of transparency and good regulatory practice, we will publish all consultation responses in full on our website, www.ofcom.org.uk.

A3.2 We have produced a coversheet for responses (see below) and would be very grateful if you could send one with your response (this is incorporated into the online web form if you respond in this way). This will speed up our processing of responses, and help to maintain confidentiality where appropriate.

A3.3 The quality of consultation can be enhanced by publishing responses before the consultation period closes. In particular, this can help those individuals and organisations with limited resources or familiarity with the issues to respond in a more informed way. Therefore Ofcom would encourage respondents to complete their coversheet in a way that allows Ofcom to publish their responses upon receipt, rather than waiting until the consultation period has ended.

A3.4 We strongly prefer to receive responses via the online web form which incorporates the coversheet. If you are responding via email, post or fax you can download an electronic copy of this coversheet in Word or RTF format from the 'Consultations' section of our website at www.ofcom.org.uk/consult/.

A3.5 Please put any parts of your response you consider should be kept confidential in a separate annex to your response and include your reasons why this part of your response should not be published. This can include information such as your personal background and experience. If you want your name, address, other contact details, or job title to remain confidential, please provide them in your cover sheet only, so that we don't have to edit your response.

Cover sheet for response to an Ofcom consultation

BASIC DETAILS

Consultation title:

To (Ofcom contact):

Name of respondent:

Representing (self or organisation/s):

Address (if not received by email):

CONFIDENTIALITY

Please tick below what part of your response you consider is confidential, giving your reasons why

Nothing ☐ Name/contact details/job title ☐

Whole response ☐ Organisation ☐

Part of the response ☐ If there is no separate annex, which parts?

If you want part of your response, your name or your organisation not to be published, can Ofcom still publish a reference to the contents of your response (including, for any confidential parts, a general summary that does not disclose the specific information or enable you to be identified)?

DECLARATION

I confirm that the correspondence supplied with this cover sheet is a formal consultation response that Ofcom can publish. However, in supplying this response, I understand that Ofcom may need to publish all responses, including those which are marked as confidential, in order to meet legal obligations. If I have sent my response by email, Ofcom can disregard any standard e-mail text about not disclosing email contents and attachments.

Ofcom seeks to publish responses on receipt. If your response is non-confidential (in whole or in part), and you would prefer us to publish your response only once the consultation has ended, please tick here. ☐

Name Signed (if hard copy)

Annex 4

Consultation questions

A4.1 The questions set out in the consultation are listed below:

Question 3.1*: Do you agree with Ofcom's proposal that Openreach be required to provide the full functionality for the WLR Core Rental service (i.e. including the option of business directory listing) at the time of the WLR3 software release – Release 1400? If you do not agree, please give reasons for your answer.*

Question 3.2*: Do you agree with Ofcom's proposal for a new condition to cap the charge for WLR business level of service at its current level (£110) until the introduction of the new WLR Core Rental service with the option of business directory listing? If you do not agree with the setting of the charge ceiling, please give reasons for your answer. If you consider that the ceiling should not be withdrawn before the end of the charge controls (March 2010), or you believe it should be withdrawn at some other date during the charge controls, please give reasons for your answer.*

Question 4.1*: Do you agree that enhanced care levels should be removed from the basis of charges and cost orientation obligations imposed by SMP conditions AAA3.1 and AAA10.2, as set out in the proposed direction at Annex 6?*

Question 4.2*: Do you agree with Ofcom's proposal to monitor the setting of charges for enhanced care level options for WLR with the backstop of enforcement under other SMP conditions and Competition Law to prevent exploitative or unfair pricing?*

Annex 5

Service Harmonisations proposals

Introduction

A5.1 A key related development in considering the appropriate regulatory framework for WLR services is the service harmonisation initiative currently being undertaken by Openreach in conjunction with the OTA and interested Communications Providers.

A5.2 The aim of this initiative is to rationalise the existing set of 8 distinct service levels for WLR and LLU to 4 levels with (near) identical service terms for WLR and LLU – see charts below:

Existing Services

Existing service	**Key Services terms**
WLR Basic Standard Care	96 hr clear fault (Monday to Friday)
WLR Basic Prompt Care	72 hr clear fault (Monday to Saturday)
WLR Premium Standard Care	48 hr clear fault (Monday to Friday)
WLR Premium Prompt Care	48 hr clear fault (Monday to Saturday)
LLU Standard Care	40 hr clear fault (Monday to Sunday)
WLR Total Care / WLR expediate	24 hr clear fault (Monday to Sunday)
LLU enhanced care	20 hr clear fault (Monday to Sunday)
LLU enhanced care+ on demand	5 hrs clear fault (reasonable endeavour)

Service Harmonisation proposals

Level	Description	Standard Engineer Working Times
1	End of next working day + 1 working day	Monday – Friday 08:00 – 18:00
2	End of next working day	Monday – Saturday 08:00 – 18:00
3	In by 13:00 fix same day, in after 13:00 fix by 13:00 next day (incl bank holidays)	Monday – Sunday 08:00 – 18:00
4	X-Hour repair	Monday – Sunday 24/7
Bolt-ons		
Saturday	Applies to levels 1	08:00 – 18:00
Sunday	Applies to levels 1 & 2	08:00 – 18:00
On demand	Applies to levels 1, 2 & 3	Outside of above times (TRC)
Temporary increases in the service level for a line/ fault		
Just as Levels 1 – 4 above will be available as rental options, a suite of multi-level expedites, or on demand temporary increases in the service levels, will be available to purchase. These will take a line from its current service level to any higher level.		

A5.3 The advantages of this approach are its simplification of the care options, parity between LLU and WLR and the free choice between prepay services (i.e. regular payments for guaranteed care) or on demand.

Annex 6

Legal Instruments

PART I – SETTING OF, AND MODIFICATION TO, SMP CONDITIONS

NOTIFICATION UNDER SECTION 48(1) OF THE COMMUNICATIONS ACT 2003

Setting of, and modification to, SMP services conditions as a result of the market power determination made by Ofcom in its statement entitled *Review of the fixed narrowband services wholesale markets*, published on 15 September 2009, in respect of the services market for wholesale analogue exchange line services in the United Kingdom but excluding the Hull Area in which it has been determined that BT is a person having significant market power

Background

1. On 28 November 2003, the Director General of Telecommunications (the **"Director"**) published a statement entitled *Review of the fixed narrowband line, call origination, conveyance and transit markets*[61], the Notification which set SMP Services Condition AA4, imposing a charge control on (amongst other services) analogue Wholesale Line Rental (**"WLR"**) Services.

2. On 29 December 2003, Ofcom took over the functions and responsibilities under the Communications Act 2003 relating to the EC Communications directives from the Director.

3. On 10 February 2005, Ofcom published a statement entitled *Modifications to BT's SMP services conditions AA4, BA4 and PA1*[62].

4. On 24 January 2006, Ofcom published a statement entitled *Wholesale Line Rental : Reviewing and setting charge ceilings for WLR services*[63]. SMP Condition AA4 was disapplied to analogue WLR services and charge ceilings were introduced.

5. On 19 March 2009, Ofcom published a consultation document entitled *Review of the fixed narrowband wholesale markets*[64] (the **"Wholesale Consultation"**). The Wholesale Consultation proposed, amongst other matters:

- that wholesale analogue exchange line services be defined as a market;
- that BT hold SMP in that defined market;
- that BT be subject, as an appropriate SMP condition, to a basis of charges obligation;
- that BT be subject, as an appropriate SMP condition, to an obligation to supply a wholesale analogue WLR service; and

61 http://www.ofcom.org.uk/static/archive/Oftel/publications/eu_directives/2003/fix_narrow0803_1.pdf
62 http://www.ofcom.org.uk/consult/condocs/bt_smp/amend_ccc/btsmp_amend_ccc.pdf
63 http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/statement.pdf
64 http://www.ofcom.org.uk/consult/condocs/review_wholesale/

- that the required wholesale analogue WLR service be subject to a charge control.

6. The Wholesale Consultation further proposed that the method and design as to how that charge control should be applied, should be considered in a separate consultation.

7. On 3 July 2009, Ofcom published a consultation entitled *Charge Controls for Wholesale Line Rental and related services*[65] (the **"WLR Consultation"**) setting out proposals for the imposition of a charge control on analogue WLR line rental services and ancillary services, modifying the basis of charges SMP condition proposed in the Wholesale Consultation and proposing the phased withdrawal of existing charge ceilings applied to analogue WLR products.

8. On 15 September 2009, Ofcom published a statement entitled *Review of the fixed narrowband wholesale markets, statement and further consultation*[66] (the **"Wholesale Statement"**) which, amongst other things, adopted the proposals from the Wholesale Consultation set out at paragraph 5 above, including the setting of SMP condition AAA3 imposing a basis of charges obligation.

9. This Notification relates to the setting of SMP condition AAA4(WLR) and the modification of SMP condition AAA3 under the market definitions and market analysis as set out in the Wholesale Statement in order to address the identified risk of BT having the ability and the incentive to price excessively.

Decisions

10. Ofcom hereby decides, in accordance with section 48(1) of the Act, to set SMP condition AAA4(WLR), set out in Schedule 1 to this Notification imposing charge controls for analogue WLR to be applied to BT.

11. The effect of, and Ofcom's reasons for deciding to set, the SMP conditions set out in Schedule 1 to this Notification are contained in Sections 3 to 8 of the document accompanying this Notification.

12. Ofcom hereby also decides to modify SMP Condition AAA3, as set out in Schedule 2 to this Notification, in order that WLR line rental charges by BT are not to be subject to the basis of charges obligation applied to the wholesale analogue exchange lines market.

13. The effect of, and Ofcom's reasons for deciding to modify, SMP conditions AAA3 as set out in Schedule 2 to this Notification are contained in Section 8 of the document accompanying this Notification.

Ofcom's duties and legal tests

14. In making the decisions set out in this Notification, Ofcom considers that the setting of, and modification to, the SMP conditions referred to in paragraphs 12 and 14 of this Notification comply with the requirements of sections 45 to 47, 87 and 88 of the Act as appropriate and relevant to each of those SMP conditions.

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[65] http://www.ofcom.org.uk/consult/condocs/wlrcc/wlrcc.pdf
[66] http://www.ofcom.org.uk/consult/condocs/wnmr_statement_consultation/main.pdf

15. In making all of those decisions, Ofcom has considered and acted in accordance with its general duties set out in section 3 of the Act and the six Community requirements in section 4 of the Act.

16. Copies of this Notification and the accompanying explanatory statement have been sent to the Secretary of State for Business Innovations and Skills in accordance with section 50(1)(a) of the Act, as well as the European Commission and to the regulatory authorities of every other member State in accordance with section 50(2) of the Act.

Interpretation

17. Except for references made to the identified services market in this Notification and except as otherwise defined in paragraphs above and paragraph 18 of this Notification, words or expressions used shall have the same meaning as they have been ascribed in the Act.

18. In this Notification—

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

(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 1159 of the Companies Act 2006.

19. Schedules 1 and 2 to this Notification shall form part of this Notification.

20. Unless otherwise stated in the Schedules to the Notification, the decisions set out above shall take effect on the day this Notification is published.

Gareth Davies

Competition Policy Director

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

26 October 2009

SCHEDULE 1

Setting of SMP services condition AAA4(WLR)

1. In Part 2 of Schedule 1 to the Notification published at Annex 7 of the final statement Review of the fixed narrowband services wholesale markets published on 15 September 2009 by Ofcom, there shall be set the following SMP services condition AAA4(WLR) by inserting it after Condition AAA4(CO)—

Condition AAA4(WLR) - Charge controls for WLR services

AAA4(WLR).1 Beginning with the Rental Effective Date, the Dominant Provider shall provide Analogue Core WLR Rental and shall not charge more than the amount of £100.68 per annum for it during the period beginning on 23 November 2009 and ending on 31 March 2010.

AAA4(WLR).2 For the period beginning on 23 November 2009, and ending on 31 March 2010, the Dominant Provider shall not charge more than:

b. for the WLR transfer charge, the amount of £3.00;
c. for the WLR new connection charge, the amount of £67.00.

AAA4(WLR).3 Without prejudice to the generality of Condition AAA3, and subject to paragraphs AAA4(WLR).7 and AAA4(WLR).9, the Dominant Provider shall take all reasonable steps to secure that, at the end of the Relevant Year, the Percentage Change (determined in accordance with paragraph AAA4(WLR).5) in:

a. the charge for Analogue Core WLR rental;
b. WLR transfer charge;
c. WLR new connection charge;

in each of the three single charge categories of products and/or services specified in sub-paragraphs (a) to (c) above is not more than the Controlling Percentage (determined in accordance with paragraph AAA4(WLR).6).

AAA4(WLR).4 For the purpose of complying with paragraph AAA4(WLR).3, the Dominant Provider shall take all reasonable steps to secure that the revenue it accrues as a result of all individual Charge Changes during the Relevant Year shall be no more than that which it would have accrued had all of those Charge Changes been made at 1 April in the Relevant Year. The Dominant Provider shall be deemed to have satisfied this obligation where, by example in the case of a single Charge Change in the Relevant Year, the following formula is satisfied:

$RC(1 - D) \leq TRC$

where:

RC is the revenue change associated with the single Charge Change made in the Relevant Year, calculated by the relevant Percentage Change immediately following the Charge Change multiplied by the revenue accrued during the Relevant Financial Year;

TRC is the target revenue change required in the Relevant Year to achieve compliance with paragraph AAA4(WLR).3, calculated by the Percentage Change required in the Relevant Year in question to achieve compliance with paragraph

AAA4(WLR).3 multiplied by the revenue accrued during the Relevant Financial Year; and

D is the elapsed proportion of the Relevant Year in question, calculated as the date on which the Charge Change takes effect, expressed as a numeric entity on a scale ranging from 1 April = 0 to 31 March = 364, divided by 365.

AAA4(WLR).5 The Percentage Change for the purposes of each of the products and/or services specified in paragraphs AAA4(WLR).3(a) to (c) shall be calculated for the purposes of complying with paragraph AAA4(WLR).3 by employing the following formula:

$$C_t = \frac{(p_t - p_0)}{p_0}$$

where:

C_t is the Percentage Change in charges for the single charge category in question at a particular time *t* during the Relevant Year;

p_0 is the published charge made by the Dominant Provider for the single charge category in question at the beginning of the Relevant Year excluding any discounts offered by the Dominant Provider; and

p_t is the published charge made by the Dominant Provider for the single charge category in question at the time *t* during the Relevant Year excluding any discounts offered by the Dominant Provider.

AAA4(WLR).6 The Controlling Percentage in relation to the Relevant Year means:

a. for the charge for Analogue Core WLR Rental, RPI increased by 3.8 percentage points:

b. for the WLR transfer charge, RPI increased by 3.8 percentage points; and

c. for the WLR new connection charge, RPI decreased by 16 percentage points.

AAA4(WLR).7 Where:

(a) the Dominant Provider makes a material change (other than to a Charge) to any Controlled Analogue WLR Services for which a Charge is charged;
(b) the Dominant Provider makes a change to the date on which its financial year ends; or
(c) there is a material change in the basis of the Retail Prices Index,

paragraphs AAA4(WLR).1 to AAA4(WLR).6 shall have effect subject to such reasonable adjustment to take account of the change as Ofcom may direct to be appropriate in the circumstances.

AAA4(WLR).8 The Dominant Provider shall, no later than three months after the end of the Relevant Year, supply to Ofcom, in writing, the data necessary to perform the calculation of the Percentage Change. The data shall include:

(a) pursuant to Condition AAA4(WLR).5, the calculated Percentage Change relating to Analogue WLR Services;
(b) pursuant to Condition AAA4(WLR).4, calculation of the revenue accrued as a result of all relevant individual charge changes during the Relevant Year compared to the target revenue change;
(c) all relevant data the Dominant Provider used in the calculation of the percentage change C_t pursuant to Conditions AAA4(WLR).5;
(d) all relevant revenues accrued during the Relevant Financial Year in respect of Controlled Analogue WLR Services;
(e) published charges made by the Dominant Provider at time *t* during the Relevant Year excluding any discounts offered by the Dominant Provider;
(f) the relevant published charge at the start of the Relevant Year; and
(g) other data necessary for monitoring compliance with the charge control.

AAA4(WLR).9 If it appears to Ofcom that the Dominant Provider is likely to fail to secure that the Percentage Change does not exceed the Controlling Percentage for the Relevant Year, the Dominant Provider shall make such adjustment to any of its charges for the provision of Controlled Analogue WLR Services and by such day in that Relevant Year (or if appropriate in Ofcom's opinion, by such day that falls after the end of that Relevant Year) as Ofcom may direct for the purpose of avoiding such a failure.

AAA4(WLR).10 Paragraphs AAA4(WLR).1 to AAA4(WLR).9 shall not apply to such extent as Ofcom may direct.

AAA4(WLR).11 The Dominant Provider shall comply with any direction Ofcom may make from time to time under this Condition.

AAA4(WLR).12 In this Condition:

(a) "Analogue Core WLR Rental" means, unless Ofcom directs otherwise from time to time for the purpose of the meaning of this expression, such services as the Dominant Provider is required to provide under SMP services condition AAA10.1(a) and which on the date this Condition takes effect include:

iii. the rental of an analogue exchange line for control and billing purposes;

iv. maintenance which is part of the service provided by the Dominant Provider in consideration of the charge for an Exchange Line and includes a maintenance service level with a fault repair time of no more than provided for Level 1 service care level for Basic lines, as defined in the Dominant Provider's standard terms and conditions; and

v. one residential style main directory listing per telephone number;

(b) "WLR transfer charge" means a charge for the transfer of control of an analogue access line;

(c) "WLR new connection charge" means a charge for the connection of a new analogue line to a premises;

(d) "Charge" means for the purposes of paragraph AAA4(WLR).7, the charge (being in all cases the amounts offered or charged by the Dominant Provider) to a Communications Provider for the Controlled Analogue WLR Service;

(e) “Charge Change” means a change to any of the charges for the provision of Controlled Analogue WLR Services;

(f) “Controlled Analogue WLR Services” means those services that are subject to price controls under paragraphs AAA4(WLR).1, AAA4(WLR).2 and AAA4(WLR).6;

(g) “Controlling Percentage” is to be determined in accordance with paragraph AAA4(WLR).5;

(h) “Ofcom” means the Office of Communications;

(i) “Percentage Change” has the meaning given to it in paragraph AAA4(WLR).5;

(j) “Relevant Financial Year” means the period of 12 months beginning on 1 April 2009 and ending on 31 March 2010;

(k) “Relevant Year” means the period of 12 months beginning on 1 April 2010 and ending on 31 March 2011;

(l) “Retail Prices Index” means the index of retail prices compiled by an agency or a public body on behalf of Her Majesty’s Government or a governmental department (which is the Office of National Statistics at the time of publication of this Notification) from time to time in respect of all items; and

(m) “RPI” means the amount of the change in the Retail Prices Index in the period of twelve months ending on 31 March immediately before the beginning of a relevant year, expressed as a percentage (rounded to two decimal places) of that Retail Prices Index at the beginning of that first mentioned period.

SCHEDULE 2

Modification to SMP service condition AAA3

1. SMP Condition AAA3 shall be modified by inserting the following new paragraph AAA3.2(a) after paragraph AAA3.2 of Condition AAA3 in Part 2 of Schedule 1 to the Notification published at Annex 7 of the statement entitled *Review of the fixed narrowband services wholesale markets* published on 15 September 2009 by Ofcom—

"AAA3.2(a) For the avoidance of doubt, except for the charge for Analogue Core WLR Rental, where the charge offered, payable or proposed for Network Access covered by Condition AAA1(a) is for a service which is subject to the charge control under Condition AAA4(WLR) the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that such a charge satisfies the requirements of paragraph AAA3.1 above. For the purpose of this Condition, the expression "Analogue Core WLR Rental" shall have the meaning it has for Condition AAA4(WLR) from time to time."

PART II – PROPOSED SETTING OF AN SMP CONDITION

NOTIFICATION UNDER SECTION 48(2) OF THE COMMUNICATIONS ACT 2003

Proposed setting of SMP service condition AAA4(B) as a result of the market power determination made by Ofcom in its statement entitled *Review of the fixed narrowband services wholesale markets*, published on 15 September 2009, in respect of the services market for wholesale analogue exchange line services in the United Kingdom but excluding the Hull Area in which it has been determined that BT is a person having significant market power

Background

1. On 28 November 2003, the Director General of Telecommunications (the **"Director"**) published a statement entitled *Review of the fixed narrowband line, call origination, conveyance and transit markets* (the **"2003 Statement"**)[67] setting out his conclusions of the market analyses he had carried out on the relevant markets. Pursuant to sections 48(1) and 79 of the Act and by way of publication of a Notification published at Annex A (the **"November 2003 Notification"**) to the 2003 Statement, the Director identified (among others) the markets for wholesale residential analogue exchange line services and wholesale business analogue exchange line services in the UK, excluding the Hull Area as relevant services markets for which he determined BT to be a person having significant market power (**"SMP"**).

2. As a result, the Director set certain SMP conditions to apply on BT in those two above-mentioned services markets, including:

(a) SMP condition AA3, which required BT to secure that its charges are reasonably derived from the costs of provision 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

(b) SMP condition AA10, which required BT to provide specific Wholesale Line Rental Services on reasonable terms and modify its charges for the provision of Wholesale Line Rental in the manner in which the Director may direct.

3. On 29 December 2003, Ofcom took over the functions and responsibilities under the Communications Act 2003 relating to the EC Communications directives from the Director.

4. On 10 February 2005, Ofcom published a statement entitled *Modifications to BT's SMP services conditions AA4, BA4 and PA1*[68]*.*

5. On 24 January 2006, Ofcom published a statement entitled *Wholesale Line Rental : Reviewing and setting charge ceilings for WLR services*[69]. SMP Condition AA4 was disapplied to analogue WLR services and the following charge ceilings were introduced by a direction (the **"2006 Direction"**, as published at Annex 1 to that statement) given by Ofcom under SMP conditions AA3 and AA10, respectively:

"1. The Dominant Provider shall not charge more than:

[67] http://www.ofcom.org.uk/static/archive/Oftel/publications/eu_directives/2003/fix_narrow0803_1.pdf
[68] http://www.ofcom.org.uk/consult/condocs/bt_smp/amend_ccc/btsmp_amend_ccc.pdf
[69] http://www.ofcom.org.uk/consult/condocs/wlrcharge/statement/statement.pdf

(a) for the annual rental of a Wholesale Analogue Line Rental (residential quality of service), £100.68 (the charge for which shall be pro rated and levied on no less than a quarterly basis);

(b) for the annual rental of a Wholesale Analogue Line Rental (business quality of service), £110.00 (the charge for which shall be pro rated and levied on no less than a quarterly basis);

(c) for the Existing Line Transfer of a single analogue Exchange Line (residential quality of service), £2.00;

(d) for the Existing Line Transfer of a single analogue Exchange Line (business quality of service), £2.00;

(e) for the New Line Installation (analogue) (residential quality of service), £88.00; and

(f) for the New Line Installation (analogue) (business quality of service), £88.00."

6. On 19 March 2009, Ofcom published a consultation document entitled *Review of the fixed narrowband wholesale markets*[70] (the **"Wholesale Consultation"**). The Wholesale Consultation (amongst other things) proposed that:

(a) wholesale analogue exchange line services be defined as a single market for the United Kingdom, except the Hull Area, in place of the two separately defined services markets referred to in paragraph 1 above;

(b) BT be determined as a person having SMP in that defined market;

(c) BT be subject, by means of appropriate SMP conditions, to requirements of:

(i) providing Network Access on reasonable request by a Third Party in that single market (now Condition AAA1(a));

(ii) unless otherwise directed, charges being reasonably derived reasonably 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 (now Condition AAA3);

(iii) providing Wholesale Line Rental on reasonable request by a Third Party in that single market (now Condition AAA10), including a specific basis of charges requirement in respect of such provision;

(iv) the required wholesale analogue WLR service be subject to a charge control;

(d) as result of the above proposals to set new SMP conditions, the SMP conditions existing at that time be revoked.

7. The Wholesale Consultation further proposed that the method and design as to how that charge control should be applied, should be considered in a separate consultation.

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[70] http://www.ofcom.org.uk/consult/condocs/review_wholesale/

8. On 3 July 2009, Ofcom published a consultation entitled *Charge Controls for Wholesale Line Rental and related services*[71] (the **"WLR Consultation"**) setting out proposals for the imposition of a charge control on analogue WLR line rental services and ancillary services, modifying the basis of charges SMP condition proposed in the Wholesale Consultation and proposing a phased withdrawal of existing charge ceilings applied to analogue WLR products under the 2006 Direction.

9. On 15 September 2009, Ofcom published a statement entitled *Review of the fixed narrowband wholesale markets, statement and further consultation*[72] (the **"Wholesale Statement"**) which (amongst other things) in the Notification published at its Annex 7 (the **"September 2009 Notification"**) adopted the proposals from the Wholesale Consultation set out at paragraph 6 above, including the setting of SMP conditions AAA1(a), AAA3 and AAA10 and the revocations of SMP conditions for exchange line services markets (except for ISDN30) such as SMP conditions AA3 and AA10 under which the 2006 Direction had previously been given.

10, On 26 October 2009, Ofcom published its statement entitled *Charge controls for Wholesale Line Rental and related services* (the **"WLR Charge Controls Statement"**) to conclude on proposals set out in the WLR Consultation, including the setting of SMP condition AAA4(WLR) to impose charge controls on BT for WLR services and the modification to SMP condition AAA3.

11. This Notification now relates to the proposed setting of a new SMP condition AAA4(B) under the market definition and market analysis as set out in the Wholesale Statement in order to address the identified risk of BT having the ability and the incentive to price excessively. In particular, in light of the revocation of the SMP conditions referred to in paragraph 9 above, Ofcom considers it necessary to maintain the charge ceiling for the annual rental of a Wholesale Analogue Line Rental (business quality of service) referred to in paragraph 5 above for a transitional period for reasons discussed in the document accompanying this Notification by means of an SMP condition to revive in force that part of the 2006 Direction. The remaining charge ceilings under the 2006 Direction have ceased to have effect by the revocation of those SMP conditions, so it is no longer necessary for Ofcom to proceed with its proposed withdrawal of that Direction at Part II of Annex 9 to the WLR Consultation.

Proposal in this Notification

12. Ofcom hereby proposes, in accordance with section 48(2) of the Act and in relation to the services market identified in paragraph 12(a)(i) of the September 2009 Notification, to set SMP condition AAA4(B) to apply to BT as set out in the Schedule to this Notification, which condition imposes a charge ceiling for the annual rental of a Wholesale Analogue Line Rental (business quality of service).

13. The effect of, and Ofcom's reasons for proposing to set, that SMP condition are contained in Section 8 of the document accompanying this Notification.

[71] http://www.ofcom.org.uk/consult/condocs/wlrcc/wlrcc.pdf
[72] http://www.ofcom.org.uk/consult/condocs/wnmr_statement_consultation/main.pdf

Ofcom's duties and legal tests

14. In making the proposal set out in this Notification, Ofcom considers that the proposed setting of the SMP condition referred to above complies with the requirements of sections 45 to 47, 87 and 88 of the Act as appropriate and relevant.

15. In making that proposal, Ofcom has considered and acted in accordance with its general duties set out in section 3 of the Act and the six Community requirements in section 4 of the Act.

16. Copies of this Notification and the accompanying explanatory statement have been sent to the Secretary of State for Business Innovations and Skills in accordance with section 50(1) of the Act, as well as the European Commission and to the regulatory authorities of every other member State in accordance with section 50(3) of the Act.

Interpretation

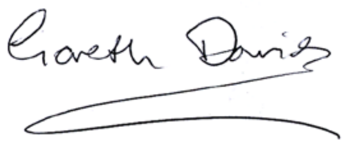
17. Except for references made to the identified services markets in this Notification and as otherwise defined in paragraphs set out above and paragraph 18 of this Notification, words or expressions used shall have the same meaning as they have been ascribed in the Act.

18. In this Notification—

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

(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 1159 of the Companies Act 2006.

19. The Schedule to this Notification shall form part of this Notification.



Gareth Davies

Competition Policy Director

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

26 October 2009

SCHEDULE

[*Proposed*] Setting of SMP services condition AAA4(B)

1. In Part 2 of Schedule 1 to the Notification published at Annex 7 of the statement entitled *Review of the fixed narrowband services wholesale markets* published on 15 September 2009 by Ofcom, there shall be set the following SMP services condition AAA4(B) by inserting it after Condition AAA4(WLR)—

Condition AAA4(B) - Charge ceiling for Analogue WLR (business quality)

AAA4(B).1 The Dominant Provider shall not charge more than the amount of £110.00 per annum for the annual rental of a Wholesale Analogue Line Rental (business quality of service).

AAA4(B).2 The following requirements shall not apply in respect of the requirement set out in paragraph AAA(B).1 above:

(a) the requirement of Condition AAA3.1 (Basis of charges) on the Dominant Provider to secure, and be able to demonstrate to the satisfaction of Ofcom, unless Ofcom directs otherwise from time to time, that each and every charge offered, payable or proposed for Network Access covered by Condition AAA1(a) is 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

(b) the requirement of Condition AAA10.2 (Requirement to provide Wholesale Line Rental etc.) on the Dominant Provider to ensure, unless Ofcom directs otherwise from time to time, that charges of providing WLR services in paragraph AAA10.1 are based on the forward looking long-run incremental cost, except where the Dominant Provider and Third Party have agreed another basis for the charges.

AAA4(B).3 This Condition, including the requirement set out in paragraph AAA(B).1 above, shall no longer apply with effect from (and including) the date on which a direction given by Ofcom, in accordance with section 49 and under Condition AAA(WLR).12(a), takes effect to include a requirement on the Dominant Provider to provide a business style listing, where the Dominant Provider provides to the Third Party a WLR3 service, as defined in the Dominant Provider's standard terms and conditions, as part of the Analogue Core WLR Rental.

PART III – PROPOSED DIRECTION REGARDING REMOVAL OF COST ORIENTATION OBLIGATION FOR ENHANCED SERVICE LEVEL CARE

NOTIFICATION UNDER SECTION 49 OF THE COMMUNICATIONS ACT 2003

Proposed Direction under section 49 of the Communications Act 2003 and SMP Conditions AAA3.1 and AAA10.2 imposed on British Telecommunications plc as a result of a market power determination made by Ofcom in the *Review of the wholesale fixed narrowband markets,* dated 15 September 2009, that British Telecommunications plc has significant market power in the markets for wholesale exchange line services in the United Kingdom excluding the Hull Area

Proposal in this Notification

1. Ofcom hereby makes, in accordance with sections 49(4) of the Act, the following proposal for giving a direction in relation to the removal of Enhanced Service Level Care Services from cost orientation obligations applied to the wholesale analogue exchange line services and wholesale ISDN2 exchange line services markets.

2. The proposed direction removing Enhanced Service Level Care Services from cost orientation obligations imposed by SMP Conditions AAA3.1 and AAA10.2 is set out in the Schedule to this Notification.

3. The effect of, and the reasons for, giving the proposed direction is set out in the accompanying document.

Ofcom's duties

4. In making the proposal set out in the 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.

Making representations

5. Representations may be made to Ofcom about this proposal set out in this Notification and the accompanying consultation document by no later than 7 December 2009.

6. In accordance with section 50 of the Act, copies of this Notification have been sent to the Secretary of State, the European Commission and to regulatory authorities of every other Member State.

Interpretation

7. Except for references made to the identified services markets in this Notification and subject to paragraph 8 below, words or expressions used in this Notification shall have the same meaning as they have been ascribed in the Act.

8. In this Notification—

    (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 1159 of the Companies Act 2006;

(c) "**Enhanced Service Level Care Services**" means maintenance which is part of the enhanced service provided by the Dominant Provider in consideration of the charge for an Exchange Line and includes a maintenance service level additional to Level 1 service care level for Basic lines, as defined in the Dominant Provider's standard terms and conditions; and

(d) **"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.

9. For the purpose of interpreting this Notification—

(a) headings and titles shall be disregarded; and

(b) the Interpretation Act 1978 (c. 30) shall apply as if this Notification were an Act of Parliament.

10. The Schedule to this Notification shall form part of this Notification.

Gareth Davies

Competition Policy Director

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

26 October 2009

SCHEDULE

[*Proposed*] Direction under section 49 of the Communications Act 2003 and SMP Conditions AAA3.1 and AAA10.2 imposed on British Telecommunications plc as a result of a market power determination made by Ofcom in the *Review of the wholesale fixed narrowband markets,* dated 15 September 2009, that British Telecommunications plc has significant market power in the markets for wholesale exchange line services in the United Kingdom excluding the Hull Area

Background

1. On 15 September 2009, Ofcom published its statement entitled *Review of the wholesale fixed narrowband markets* (the "Wholesale Review Statement")*.*

2. In the Wholesale Review Statement, Ofcom determined that BT held significant market power (SMP) in various markets in the United Kingdom excluding the Hull Area including the markets for:

   (i) wholesale analogue exchange line services; and
   (ii) wholesale ISDN2 exchange line services.

3. As a result, Ofcom imposed a number of remedies on BT in order to address identified competition concerns. Those remedies included the following SMP services conditions: AAA3 and AAA10 applied to, amongst others, those markets set out at paragraph 2 above.

4. Both AAA3 and AAA10 impose a cost orientation obligation upon BT, as follows:

   AAA3.1 *Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition AAA1(a) is 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*;

   AAA10.2 *Unless Ofcom directs otherwise from time to time, the Dominant Provider shall ensure that charges of providing WLR services in paragraph AAA10.1 are based on the forward looking long-run incremental cost, except where the Dominant Provider and Third Party have agreed another basis for the charges*.

5. BT currently offers some services ('Enhanced Service Level Care Services'), within the markets described at paragraph 2 above, that provide an enhanced level of service support to rented wholesale lines. Ofcom considers that different pricing constraints apply to these services within the market and that we should not continue to apply the cost orientation obligations to these services.

Direction

6. Ofcom hereby, in accordance with section 49 of the Act, directs that SMP service Conditions AAA3.1 and AAA10.2 shall not apply to Enhanced Service Level Care Services provided by BT in support of the rental of wholesale lines for the markets set

out in paragraphs 12(a)(i) and (ii) of the Notification to the Wholesale Review Statement, that is to say:

wholesale analogue exchange line services;
wholesale ISDN2 exchange line services.

7. The effect of, and the reasons for making, this Direction is set out in the accompanying explanatory statement at section 4.

Effective date

8. This Direction shall take effect on the publication of this Direction.

Ofcom's duties

9. In making this Direction, Ofcom has considered the test set out in section 49(2) of the Act and considers that it 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

10. Ofcom also considers that, in making this Direction, it has acted in accordance with its general duties in section 3 of the Act and the six Community requirements in section 4 of the Act.

Interpretation

11. Except for references made to the identified services market in this Notification and subject to paragraph 12 below, words or expressions used in this Notification shall have the same meaning as they have been ascribed in the Act.

12. In this Notification—

(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 1159 of the Companies Act 2006;

(c) "**Enhanced Service Level Care Services**" means maintenance which is part of the enhanced service provided by the Dominant Provider in consideration of the charge for an Exchange Line and includes a maintenance service level additional to Level 1 service care level for Basic lines, as defined in the Dominant Provider's standard terms and conditions;

(d) **"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;

(e) **“Ofcom”** means the Office of Communications;

(f) **“United Kingdom”** has the meaning given to it in the Interpretation Act 1978 (c.30); and

(g) **“Wholesale Review Statement”** has the meaning given to it in paragraph 1 of this Direction.

13. For the purpose of interpreting this Notification—

(a) headings and titles shall be disregarded; and

(b) the Interpretation Act 1978 (c. 30) shall apply as if this Notification were an Act of Parliament.

[SIGNATURE]

[TITLE]

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

[DATE]

PART IV – PROPOSED DIRECTION REGARDING AMENDMENT OF THE DEFINITION OF ANALOGUE CORE WLR RENTAL

NOTIFICATION UNDER SECTION 49 OF THE COMMUNICATIONS ACT 2003

Proposed Direction under section 49 of the Communications Act 2003 and SMP Condition AAA4(WLR).14(a), imposed on British Telecommunications plc on in the Notification to *Charge controls for Wholesale Line Rental and related services* dated 26 October 2009 made as a result of a market power determination made by Ofcom in the *Review of the wholesale fixed narrowband markets,* dated 15 September 2009, that British Telecommunications plc has significant market power in the market for wholesale analogue exchange line services in the United Kingdom excluding the Hull Area

Proposal in this Notification

1. Ofcom hereby makes, in accordance with sections 49(4) of the Act, the following proposal for giving a direction in relation to the amendment of the definition of Analogue Core WLR Rental in SMP Condition AAA(WLR).14(a) in order to include, as a minimum requirement, the obligation to provide either a residential or business directory listing as part of the required service.

2. The proposed direction amending the definition of Analogue Core WLR Rental under SMP Condition AAA(WLR).14(a) is set out in the Schedule to this Notification.

3. The effect of and the reasons for, giving the proposed direction is set out in the accompanying document.

Ofcom's Duties

4. In making the proposal set out in the 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.

Making representations

5. Representations may be made to Ofcom about this proposal set out in this Notification and the accompanying consultation document by no later than 7 December 2009.

6. In accordance with section 50 of the Act, copies of this Notification have been sent to the Secretary of State, the European Commission and to regulatory authorities of every other Member State.

Interpretation

7. Except for references made to the identified services markets in this Notification and subject to paragraph 8 below, words or expressions used in this Notification shall have the same meaning as they have been ascribed in the Act.

8. In this Notification—

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

   (b) "**Analogue Core WLR Rental**" has the same meaning as set by SMP services condition AAA4(WLR).14(a), as modified by any Direction made under that condition;

(c) **“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 1159 of the Companies Act 2006;

(d) **“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;

9. For the purpose of interpreting this Notification—

(a) headings and titles shall be disregarded; and

(b) the Interpretation Act 1978 (c. 30) shall apply as if this Notification were an Act of Parliament.

10. The Schedule to this Notification shall form part of this Notification.

Gareth Davies

Gareth Davies

Competition Policy Director

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

26 October 2009

SCHEDULE

[*Proposed*] Direction under section 49 of the Communications Act 2003 and SMP Condition AAA4(WLR).14(a), imposed on British Telecommunications plc on in the Notification to *Charge controls for Wholesale Line Rental and related services* dated 26 October 2009 made as a result of a market power determination made by Ofcom in the *Review of the wholesale fixed narrowband markets,* dated 15 September 2009, that British Telecommunications plc has significant market power in the market for wholesale analogue exchange line services in the United Kingdom excluding the Hull Area

Background

1. On 15 September 2009, Ofcom published its statement entitled *Review of the wholesale fixed narrowband markets* (the "Wholesale Review Statement")*.*

2. In the Wholesale Review Statement, Ofcom determined that BT held significant market power (SMP) in various markets in the United Kingdom excluding the Hull Area including the market for wholesale analogue exchange line services.

3. As a result of that market analysis, Ofcom imposed a number of remedies on BT in order to address identified competition concerns. Additionally, Ofcom decided that a charge control should be imposed in relation to BTs supply of analogue wholesale line rental ('WLR'), in order to address the identified competition concern that BT could set excessive prices within that market. The Wholesale Review Statement confirmed that the SMP condition applying such a charge control should be set under a separate review entitled *Charge controls for Wholesale Line Rental and related services*.

4. On 26 October 2009, Ofcom published *Charge controls for Wholesale Line Rental and related services statement and further consultation* ('the WLR review')*.*

5. The WLR review set SMP condition AAA4(WLR) as the appropriate charge control on analogue WLR services following the market analysis published in the Wholesale Review Statement.

6. AAA4(WLR) requires BT to provide an Analogue Core Rental service at a price not exceeding a specified amount. AAA4(WLR).14(a) defined Analogue Core WLR Rental as follows:

> *"Analogue Core WLR Rental" means, subject to such direction as Ofcom may from time to time give under this paragraph (a), such services, as the Dominant Provider is required to provide under SMP services condition AAA10.1(a) comprising as a minimum, the following:*
>
> *i. the rental of an analogue exchange line for control and billing purposes;*
>
> *ii. maintenance which is part of the service provided by the Dominant Provider in consideration of the charge for an Exchange Line and includes a maintenance service level with a fault repair time of no more than provided for Level 1 service care level for Basic lines, as defined in the Dominant Provider's standard terms and conditions; and*
>
> *iii. one residential style main directory listing per telephone number .*

7. The requirement to provide one residential style main directory listing per telephone number reflected BTs ability to provide a residential listing but not a business listing at the time condition AAA4(WLR) became effective.

8. BT confirmed that they would need to upgrade their systems to offer a business listing on their WLR3 platform as part of an Analogue Core WLR Rental service. This upgrade would be available as part of their “Release 1400” update, currently scheduled for July 2010.

9. Once BT is in a position to offer a business listing, the definition of Analogue Core WLR Rental will be updated, by this direction, to include the provision of a WLR3 business listing, where required, as part of the minimum level of service to be provided by BT.

10. Ofcom considers that it would be inappropriate to oblige BT to supply Analogue Core WLR rental with a business listing on BT’s WLR2 platform as this is due to be phased out.

Direction

11. Ofcom hereby, pursuant to section 49 of the Act and under Condition AAA4(WLR).12(a), directs that for the expression “Analogue Core WLR Rental” there shall be substituted the following new expression in that Condition and the Condition shall read accordingly:

“(a) “Analogue Core WLR Rental” means, unless Ofcom directs otherwise from time to time for the purpose of the meaning of this expression, such services as the Dominant Provider is required to provide under SMP services condition AAA10.1(a) and which on the date this Condition takes effect include:

i. the rental of an analogue exchange line for control and billing purposes;
ii. maintenance which is part of the service provided by the Dominant Provider in consideration of the charge for an Exchange Line and includes a maintenance service level with a fault repair time of no more than provided for Level 1 service care level for Basic lines, as defined in the Dominant Provider’s standard terms and conditions; and
iii. one main directory listing per telephone number, comprising of either:
    ii. a residential style listing; or
    iii. a business style listing, where the Dominant Provider provides to the Third Party a WLR3 service, as defined in the Dominant Provider’s standard terms and conditions;”

Effective Date

12. This Direction shall take effect on the WLR Business Implementation Date.

Ofcom’s duties

13. In making this Direction, Ofcom has considered the test set out in section 49(2) of the Act and considers that it 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.

14. Ofcom also considers that, in making this Direction, it has acted in accordance with its general duties in section 3 of the Act and the six Community requirements in section 4 of the Act.

Interpretation

15. Except for references made to the identified services market in this Notification and subject to paragraph 16 below, words or expressions used in this Notification shall have the same meaning as they have been ascribed in the Act.

16. In this Notification—

(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 1156 of the Companies Act 2006;

(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) **"Ofcom"** means the Office of Communications;

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

(g) **"Wholesale Review Statement"** has the meaning given to it in paragraph 1 of this Direction.

(f) **"WLR Business Implementation Date"** means either:

(i) the date on which BT has published in a written notice on its website that the Release 1400 upgrade will be available for provision by BT to a person providing a Public Electronic Communications Network or a person providing a Public Electronic Communications Service; or

(ii) the back stop date of 31 July 2010,

whichever is the earlier;

17. For the purpose of interpreting this Notification—

(a) headings and titles shall be disregarded; and

(b) the Interpretation Act 1978 (c. 30) shall apply as if this Notification were an Act of Parliament.

[SIGNATURE]

[TITLE]

A person duly authorised in accordance with paragraph 18 of the Schedule to the Office of Communications Act 2002

[DATE]