

# OFCOM'S BUSINESS CONNECTIVITY MARKET REVIEW AND CHARGE CONTROL

AUGUST 2012

## 1 INTRODUCTION AND SUMMARY

- 1.1 As a leading provider of connectivity services we are a key stakeholder in this crucial £2BN+ market, a market which acts as the arteries of both commerce and government, underpinning the economic wellbeing of the nation. The services in this market are at the very core of our business. We serve the United Kingdom's top companies, key public sector institutions and many other communications and service providers delivering network solutions that enable them to get on with what they do best. In turn we need access to the right regulated products at the right price to ensure that we can help our customers operate their businesses as efficiently and effectively as possible, delivering for UK business in the toughest economic climate for a generation. We believe we know this market better than anyone else, serving the widest range of customer need, from the straightforward, who are both content and confident in their long standing leased line solutions, to those businesses who strive to be at the leading edge, demanding the innovative while in pursuit of the most efficient solutions for their business.
- 1.2 We need to deliver for all our customers and we look to Ofcom to address the issues of market failure that stem from enduring economic bottlenecks in connectivity access. Without the right regulatory approach we can't deliver for our customers, nor can we compete effectively, with a resulting consumer welfare loss. While UK end-consumers have little direct interest in the dynamics of this important market, they would ultimately face the consequences if the regulatory remedies imposed weren't delivering the best possible outcomes.
- 1.3 We know just how complicated this market can be and we commend Ofcom for the work that has gone into both understanding today's market dynamics and in proposing solutions intended to help address the competitive bottlenecks that exist. For the most part we think Ofcom's market analysis has struck the right note; however we think Ofcom need to reconsider some of the detail of the remedies proposed to ensure that they act as effective safeguards, countering the real day to day issues that we and our customers experience when trying to overcome the access bottlenecks where SMP has been found.
- 1.4 In our view Ofcom should not proceed with its proposal to remove cost orientation and cost accounting obligations. We view this as a huge mistake that will quickly undo much of the progress made in recent years to ensure that prices are aligned with costs. While we acknowledge that the current arrangements and information are imperfect, we are confident they can be improved. Removing these obligations without clear justification and ahead of a focused policy consultation goes against all that Ofcom upholds. To retain its regulatory integrity Ofcom must rethink its approach.
- 1.5 We consider that service migrations are one of the biggest issues for this review but in its proposals Ofcom has not done enough to address the problems we face. The markets covered

by this review are in the middle of significant change with new technology and product options giving better functionality at lower cost and yet BT is not doing enough to facilitate the move to tomorrow's products. Worse, we believe BT has been able to develop certain migration solutions that favour its own business rather than wholesale customers meaning competition is being held back.

- 1.6 Ofcom is right to define a separate Market for MISBO. An important part of this market is the local exchange backhaul that is fundamental to the purchase of LLU, VULA and the lowest cost business connectivity services such as EAD Local Access. Here the devil is in the detail as BT's competitors often need to use different products to fulfil their particular requirements compared with BT itself. This gives rise to the risk of competitive distortion if the products and pricing are not properly controlled and we don't think Ofcom has yet got the remedies right. There has to be some form of price regulation in this market and we believe that cost orientation is the right one.
- 1.7 In the alternative interface market we consider there is a real threat to effective competition in the intermediate wholesale market and Ofcom should take steps to ensure that it does not fall away, requiring regulation of BT Wholesale in a similar manner to the WBA market. This can be achieved by ensuring the largest competing operators can justify the investment to purchase the lowest cost regulated access product throughout the whole of the UK. A straightforward amendment of the EAD LA product to allow for longer distance circuits would go a long way to achieving this, with BT required take a wider market view over the location of handover points in order that operators investing in this market can generate economies of scope with their investment in NGA. This will help the largest communication providers build networks that can serve a wide rural footprint and in so doing bring competition and choice to many areas of the UK, in both retail and wholesale markets, where it is currently restricted.
- 1.8 Now isn't the time to define two separate trunk markets. The PPC market is in the latter stages of its lifecycle with no Communications Providers wanting to use their scarce resources to invest in new trunk network or tweaking existing circuit routings because of price increases not justified by cost. Ofcom's forecasts show the significant fall in the volume of traditional interface circuits and it would be inefficient for operators to be forced to re-arrange them at this late stage. Today BT's market share in the entire trunk market indicates SMP, it is too late to try and promote a competitive outcome. We urge Ofcom to retain a national trunk market.
- 1.9 Traditional Interface ('TI') services are legacy service and future demand is clearly for Alternative Interface ('AI') as well as other technologies. However TI isn't going to disappear overnight, with many consumers planning to retain their existing services for some time, as in many cases no viable alternatives are yet available. Ofcom has to safeguard the interests of these consumers, protecting them as far as possible from unjustified price rises. Customers that rely on TI circuits have seen significant increases in prices over the past three years while BT has seen profits increasing beyond what would be considered healthy. However the proposed control will see average prices increasing by a further RPI+3.25% per year and it is possible some services could increase by as much as 40% over the duration of this control.

The approach to cost modelling has not re-allocated the common costs correctly; it does not deal with them well in this unusual situation, where a rapid change in volumes from one product type to others is occurring. Although Ofcom has proposed to make adjustments to address this issue the proposals do not yet deal with all the areas of common cost and need to be amended.

- 1.10 Since Ofcom published the leased line charge control publication BT has released its 2011/12 regulatory financial statements. We believe Ofcom should now update its analysis, particularly in the alternative interface market, to ensure its base date is correct. We also believe the proposed migration credit should be recalculated as the charge control model already includes much of the cost and revenue from new connections associated with the migration from legacy to new ethernet services. The migration credit should be based only on the legacy volumes that are not already forecast to migrate during the duration of the control.
- 1.11 The detail of the charge control structure is vital and even modest changes in assumptions can have a big impact. We do not believe that prior financial year weights work well in markets such as these where the volumes are changing rapidly. We estimate that this has enabled BT to recover nearly £70m of additional revenue over the last three years. Ofcom should use either current year weights or weights from the prior six months;

## **2 STRUCTURE OF THIS RESPONSE**

- 2.1 Sections 3 to 9 of our response focus on issues which primarily relate to the business connectivity market review. Firstly setting out our views on what we consider to be key issues:
- a) cost orientation and cost accounting – there is sufficient justification for the imposition of these remedies for BCMR markets and services
  - b) migration – a critical issue that needs clear resolution in concluding this review
  - c) depth of interconnection / economies of scope – proposals to Ofcom to enable CPs to achieve comparable cost and compete more effectively with BT
  - d) MISBO regulation – is welcomed but proposals fall short for requirements for charge certainty and the prevention of excessive charges
  - e) Trunk market proposals – fail to reflect how the market is operating and the present stage of the PPC product life cycle.
- 2.2 Following this we set out answers to the questions directly raised by Ofcom in the BCMR consultation.
- 2.3 Sections 10 to 15 then address the leased line charge control. We cover some specific issues in relation to the LLCC modelling:
- a) Appropriate base year numbers – since the publication of the consultation BT has published its 2011/12 RFS. We consider the final model must be updated to reflect this newer more appropriate data set.
  - b) TI cost reallocation – we consider a far greater amount of common costs are rightly removed from the TI cost base
  - c) Migration credit – we consider that Ofcom has calculated the credit incorrectly and that a more appropriate level would be in the region of £15M
  - d) Prior year weightings – we consider that BT has earned significant extra revenue during the current control as a result of the prior year weightings and the significant volume changes in these markets. Ofcom should use weightings based upon the current year, or on a prior six month basis.
- 2.4 Following this we set out answers to the questions directly raised by Ofcom in the LLCC consultations.

## CONTENTS

Section.....	Page
1 Introduction and Summary .....	1
2 Structure of this response.....	4
3 The Business Connectivity Market Review .....	6
4 Cost orientation and Cost Accounting .....	7
5 Migration options .....	18
6 Fostering further competition in BCMR markets (depth of interconnection) .....	23
7 MISBO regulation price certainty.....	29
8 Trunk market analysis .....	31
9 Answers to BCMR questions.....	33
10 Leased Line Charge Control.....	42
11 Base year data should be based on 2011/12 RFS .....	44
12 TI common cost allocation.....	48
13 Migration credit is overstated.....	57
14 Prior year basket weights .....	62
15 Answers to LLCC questions .....	66

## 3 THE BUSINESS CONNECTIVITY MARKET REVIEW

### INTRODUCTION

- 3.1 We welcome Ofcom's BCMR and recognise the detailed level of analysis that Ofcom has undertaken to arrive at the consultation proposals. We largely agree with Ofcom's market definition and analysis although we don't believe the traditional interface trunk market should be split into two at this late stage in its lifecycle. We also continue to have concerns over the dig distance assumption used in Ofcom's geographic analysis.
- 3.2 On remedies we believe Ofcom needs to go further and consider the most important areas are as follows:
- a) We strongly object to Ofcom's proposal to remove cost orientation and cost accounting obligations. It removes the linkage of price and cost and removes information we have today to challenge BT prices. We consider charge control and cost orientation obligations to be complementary rather than substitutionary.
  - b) We consider migration is a major issue for this review yet to be resolved via the proposals that Ofcom makes. We consider that migration is a requirement of a reasonable network access offer which Ofcom must enforce as a priority. BT is presently actively discriminating between its own migration requirements and the requirements of industry.
  - c) While we welcome Ofcom's findings of the MISBO market and the proposal to designate BT with SMP, we consider that essential pricing obligations are missing from the proposed remedies. The impact is that Communications Providers will have absolutely no pricing certainty for key high bandwidth services in particular MISBO backhaul where OSA is used.
  - d) We propose that Ofcom requires BT to amend its EAD LA product in order that longer distance circuits can be obtained in rural areas. We propose that Ofcom requires BT to take a wider market view with respect to the location of handover points so that handover for BCMR AI services is aligned with those for NGA and so that we can drive better economics in access aggregation. A wider role for the OTA could be required to facilitate this.

## 4 COST ORIENTATION AND COST ACCOUNTING

### INTRODUCTION TO THE ISSUE

- 4.1 Despite finding BT with SMP, Ofcom proposes not to impose cost orientation as a remedy for any of the BCMR services. Although we consider this to be an issue for the BCMR Ofcom has chosen to present the justification for it within the LLCC consultation which was published some three weeks later.<sup>1</sup>
- 4.2 Cable & Wireless Worldwide considers that it is very important that the price of regulated services is aligned with cost and that the availability of accurate cost accounting information is an essential part of achieving that. We believe the proposal to remove both the cost orientation and cost accounting obligations is a significant failing for the following reasons:
- a) The charge controls, sub-baskets and sub-caps proposed are not capable of ensuring that all prices remain aligned with cost over time. Nor are they capable of addressing all the potential competition concerns that Ofcom itself identifies within the BCMR;
  - b) Accurate cost information is important for a variety of reasons including setting charge controls, ensuring individual prices are aligned with cost and identifying competition problems. There have been numerous problems with the accuracy of this information but the only way to get it right is to ensure transparency and encourage its use. Withdrawing the information will lead to inefficient decisions, the failure to identify problems and an even greater lack of confidence in any specific cost information sought by Ofcom. Ultimately it will be a deterrent to investment;
  - c) Ofcom's justification for the removal is weak. In places it wrongly considers its decision to be a choice between cost orientation or a charge control. The proportionality arguments appear to ignore crucial facts. Ofcom has jumped to these conclusions based upon a narrow consideration of the options when the same issues are about to be considered in a proper policy project;
- 4.3 Ofcom should not proceed with these proposals. Both the cost orientation and cost accounting obligations should be retained within the remedies for the wholesale business connectivity markets. Ofcom's current policy project, which we have been lobbying in favour of for years, is the best place for the issues to be considered and a decision made as to whether the existing remedies, modifications of those remedies, or an alternative approach is likely to deliver the best outcome. The outcome from that project can be reflected in the BCMR at the appropriate point in time.

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<sup>1</sup> The BCMR was published on the 18th June 2012 and the LLCC on the 5th July 2012

## PURPOSE OF COST ORIENTATION AND COST ACCOUNTING

- 4.4 Cost orientation has overarching benefits that are not evident in other remedies, thus giving Communications Providers confidence that the price they pay for each regulated wholesale service they need to purchase is fair, and they have the ability to challenge those prices if they believe they are not. Cable & Wireless Worldwide considers that it is very important that the price of regulated services is aligned with cost and the importance of these remedies goes much further than providing a constraint against excessive charging. Today, the cost orientation obligation sets the upper and lower bounds of what charges should apply, loosely replicating the workings of a competitive market. While charge controls go further and push the efficiency envelope in order to better replicate a well-functioning market, they are not a substitute for cost orientation, which remains the ultimate safeguard for consumers, acting as both the lifejacket and distress flare within the wider regulated economic framework. This ensures that the prices of all individual services float at an appropriate level and if necessary draws attention to any instances where pricing for any one service moves out of line with cost.
- 4.5 Given the importance we attach to this issue we have set out the role that these obligations hold in addressing various competition concerns and meeting Ofcom's objectives under the Communications Act.

### Excessive Pricing

- 4.6 The cost orientation obligation provides a constraint at the individual service, while at the same time providing the regulated firm with a degree of flexibility in the way that it sets its prices and recovers its costs. Although the use of sub-baskets and sub-caps within a charge control can provide effective constraints on individual services in the short term they will only be effective in the long term if individual prices are reset on a regular basis should they fall out of line with cost.
- 4.7 It also provides a safety net should significant changes in specific costs occur after a charge control is set. That could be because certain aspects of cost change significantly in a way not forecast and while the incentive effects of charge controls may mean that such an event should not change the overall level of the control it remains important that individual charges remain aligned with actual cost. Alternatively changes may occur if errors with the cost information come to light after the control has been set.
- 4.8 We don't consider the proposed sub-baskets and sub-caps adequately achieve these objectives because:
- a) There is too much flexibility within them. For example the Provisional Determination in the Ethernet dispute<sup>2</sup> shows the DSAC for BES 1000 in 2010/11 was £4,860 pa. The current price is £3,765 pa<sup>3</sup> and under the proposed control sub-cap it could remain at that level through-out the control. Therefore if DSAC falls at 5% per year, which is quite possible, the

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<sup>2</sup> See Dispute between Cable & Wireless and BT about BT's charges for Ethernet Services – 23rd February 2012

<sup>3</sup> Note the current price BES1000 Extended reach is £5,169 and therefore may already exceed an appropriate DSAC figure;

price will be above DSAC by the end of the control. The risk is even greater for a product like WES155 where the Provisional Determination suggests a unit DSAC of £4,366 pa which is only just above the current price, any reduction in cost over the next three years could leave the price being above Ofcom's view of DSAC. Other similar examples can be found in both the AI and TI markets. It is clearly quite possible that prices could exceed DSAC while being compliant with the charge control.

- b) Even if the flexibility allowed were further reduced to provide greater constraint it would be necessary to ensure prices are well within an acceptable range of cost ceilings and floors at the start of the control. While Ofcom may have looked at this for some charges it does not appear to have done that for all, and cannot do it for new services introduced during the control. Furthermore, such a review (and potentially resetting some prices) would need to be undertaken at each future charge control and Ofcom does not appear to have considered this requirement, let alone how it would be done in the absence of reliable cost accounting information.
- c) The control does not ensure prices remain aligned with cost in the face of any un-forecast changes in cost that impact specific services. As an example, in the 2009 LLCC Ofcom set Point of Handover prices based upon BT cost estimates that later proved to be incorrect and too high. While in that instance the problem was spotted in time for an appeal to be made, in similar circumstances the cost orientation obligation could be used to address such an issue without waiting for the next review, or re-opening the existing control.

### **Predatory Pricing**

- 4.9 The cost orientation obligation also requires that prices are set above a floor. In markets such as those in this review there are some individual services, in certain geographies, that some Communications Providers consider prospectively competitive and may wish to enter that part of the market. Absent any ex-ante constraint limiting charges from being too low the regulated entity could reduce its prices for these particular services while offsetting the revenue reduction with higher prices elsewhere in the basket. The cost orientation obligation puts a constraint on such behaviour.
- 4.10 In addition the cost accounting obligation ensures that cost information on the most important services is available to enable Communications Providers to investigate issues and bring forward any concerns. Whilst such cases are rare, possibly because the choice of building vs buying is never black and white, the protection is important in providing confidence for investment decisions.
- 4.11 It is clear that with a charge cap, particularly with such wide baskets, that the proposed control provides no constraint on prices being set at a level which is too low.

### **Discrimination and price distortion**

- 4.12 While the requirement to not unduly discriminate comes from of a separate obligation the price and cost information provided under the cost accounting obligation is vital for stakeholders to investigate any concerns in this area. Consideration of price discrimination goes much further than merely ensuring the same price is charged to all customers in similar circumstances. Therefore accounting separation is only of partial benefit in dealing with issues of discrimination. In some cases external customers have structurally different requirements to the incumbent operator's downstream business (such as backhaul where BT uses EBD but external customers also use BES and OSA). In other cases cost differences may justify some price difference but it is still necessary to understand the costs.
- 4.13 There are clear incentives for an SMP operator to set prices in a manner that increases its competitors' cost more significantly than its own costs. An obvious example is to increase the price of a service only purchased by external customers, such as interconnect services, possibly by loading common costs disproportionately to those services. However it is not sufficient only to look at services sold exclusively to external customers and the same sort of opportunity exists where the proportion of external vs internal sales varies between different services.
- 4.14 Ofcom has sought to address this type of problem through the use of sub-baskets and sub-caps. We agree that sub-baskets and sub-caps are useful ways to address such concerns and in some circumstances are likely to be more effective than cost orientation. Ofcom has used them in previous charge controls, alongside cost orientation, and we have supported that approach. However on their own they are not a thorough method of addressing this basic form of competitive distortion:
- a) They only address those issues that Ofcom foresees when designing the charge control. In practice it is not possible to spot all the areas where this might happen over the next three years;
  - b) They do not cover new services, particularly where a new service is not a replacement for an existing one;
  - c) In the absence of reliable information about cost and price, that is not proposed to be available under Ofcom's proposals, it becomes virtually impossible to bring a case under the no undue discrimination obligation that considers the complex cases that go beyond just checking that the same price is charges to all customers.
- 4.15 In this particular market review, where the proposed charge control baskets are particularly wide, there are many potential areas of concern. Here we list only a few of them in order to illustrate the complexity of the problem:
- a) There are some significant variations in the proportion of services provided internally vs externally. For example in TI less than 60% of sales of 2Mbit/s local ends and terminating segments are provided internally while over 80% of 2Mbit/s and 45Mbit/s trunk is internal,

and over 90% of 155Mbit/s local ends and trunk. In AI only 57% of WES 10 is provided internally, compared with 75% for EAD 10, and 82% for EAD 1000. Only 54% of Ethernet main link is provided internally. Of course 0% of BES is provided internally;

- b) Some of the services covered by this review are undergoing quite significant changes in volumes due to migration from legacy services to new services. In this response we highlight some of the migration problems we are experiencing that mean our migration requirements are not dealt with as well as those of BT and therefore even more significant variations between the proportions of internal verses external sales could exist within this timescale of this control;
- c) BT and external Communications Providers sometimes use different services in different ways. For example in the provision of backhaul, another of the key issues we highlight for this review. EBD is the service that BT uses to meet its exchange backhaul service. However EBD is designed specifically to suit BT purposes and external customers are likely to continue to use a variety of different services including BES, EAD and OSA. Absent any additional constraints it will be possible for BT to raise the cost of its competitors' backhaul in relation to its own through the pricing of these various products;
- d) Ofcom proposes to use a sub-basket to constrain the price of TI interconnection services but don't propose any further constraint on individual prices within this sub-basket. It is only one year ago that Ofcom completed its review of Point of Handover charges where it found it was necessary to re-balance<sup>4</sup> the charges for Type 1 and Type 2 handovers as those set by BT did not properly align with cost however Ofcom no longer proposes any constraint on how BT chooses to recover the costs between these two types of handover.

### **Price Certainty**

4.16 Price certainty is important for a number of reasons:

- a) Many customers want to sign up to a price fixed over the term of their contract or at least several years of the contract, the greater the confidence and certainty a retail provider has in their future wholesale costs the better able they will be to compete for such contracts;
- b) Alternative Communications Providers do have some alternatives even in uncompetitive markets, for example some providers will have the ability to deploy their own fibre based access in some locations, others may consider alternative technologies. These are decisions taken over a 1 to 3 year time horizon and yet will only be made efficiently if the provider can reasonably forecast price over the relevant time period;
- c) Other investment decisions, such as whether to extend their network to further local exchanges, must take an even longer time horizon into account making the ability to take a long term view of price even more important.

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<sup>4</sup> The main purpose of the project was to consider the proper amount of cost that should be recovered but as part of that it was also necessary to change the relative amount recovered by Type A and Type B handovers.

- 4.17 Ofcom considers that the basket structure of its proposed controls gives price certainty. However with such wide baskets, and in the case of AI a fairly significant year on year control price reduction, price changes could be very significant over the three years of the control. For example if BT targeted AI decreases at only half of the services in the control they could reduce them by close to 50% over the three years while maintaining the others constant under the RPI-RPI sub-cap.
- 4.18 This represents significant uncertainty in price even within the structure of the control proposed by Ofcom. In addition as we have already shown in paragraphs 4.8 and 4.9 above, some of those prices may exceed DSAC or be set under DLRIC within the life of just one charge control. We consider that the cost orientation obligation combined with the cost accounting information gives rise to material additional price certainty which is not available under Ofcom's proposals. Firstly, the cost orientation obligation ensures prices must stay reasonably aligned with cost and secondly the comparison between cost (including floors and ceilings) and price is an additional information source that helps predict the long term direction of price movements.

#### **Efficient Investment**

- 4.19 The combination of the ability for Communications Providers to make an educated prediction of future price changes and the confidence that prices are generally aligned with cost are both essential factors for encouraging investment and ensuring that such investment is efficient. The UK telecoms market is already littered with examples of under achieving investments that had been justified by the price of regulated services that did not reflect the underlying cost of the service. Price changes after the investment, that should have been predictable or maybe even challenged under the regulatory framework, have changed the economics.
- 4.20 Ofcom raises exactly this concern within the BCMR consultation itself when considering the issue passive remedies. One of the concerns raised is that the introduction of passive remedies could give rise to inefficient competitive entry<sup>5</sup> because BT recovers more of its common cost on high bandwidth services for which passive remedies may provide an alternative. However as the BCMR analysis has shown other Communications Providers are already investing in these high bandwidth services and the risk of inefficient entry is already there.
- 4.21 Of course the existence of cost orientation and cost information does not guarantee investment will be efficient, those remedies have been in place for some time but still poor decisions will have been made. However the crucial fact is that if a level playing field for investment is to exist then investors must have the ability to build confidence in their investment case. Without doubt the removal of the cost orientation and cost accounting obligations removes some of the linkage between price and cost, and the information to assess it. Confidence will be damaged and the quality of investment decisions can only get worse.

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<sup>5</sup> See paragraph 8.62 of BCMR consultation 2012

## **OFCOM'S JUSTIFICATION**

4.22 Although we consider a decision regarding whether to impose cost orientation and cost accounting obligations is one for the BCMR Ofcom has presented its justification within the LLCC consultation because the design of its charge control forms a key part of Ofcom's justification for not imposing these remedies. Ofcom considers that it would not be proportionate to impose cost orientation remedies in addition to the charge control given its objectives, to prevent excessive pricing, because it considers that the:

- a) control, its sub-baskets and sub-caps give a greater degree of certainty than cost orientation;
- b) significant forecast changes in volumes, and the proposal to reallocate common cost between markets, makes the DSAC and DLRIC figures harder to predict than in other markets;
- c) charge control is designed to bring overall prices into line with fully allocated costs by the end of the control whereas cost orientation sets a ceiling based upon DSAC which would allow return substantially above BT's cost of capital;
- d) proposed sub-baskets and sub-caps will constrain individual charges where it considers there is a specific risk of excessive pricing; and
- e) cost orientation obligation is subject to a time lag.

4.23 We do not agree with Ofcom's analysis on this issue. In this section we explain why we consider Ofcom should have reached a different conclusion on this issue.

### **Not just excessive pricing**

4.24 The potential competitive concerns identified in the BCMR are wider than just the requirement to prevent excessive charging and Ofcom's analysis of the proportionality of the cost orientation and cost accounting obligations should take into all the issues.

4.25 Ofcom itself identifies many of these issues in the BCMR and although it proposes remedies to address them in many cases those remedies will be either inadequate or sub optimal without the additional obligations that arise from cost orientation and cost accounting. For example table 85 (and to a lesser extent table 83) identifies:

- a) Price discrimination - but the obligation not to unduly discriminate will be hard to enforce without the cost accounting information that is required to be provided today;
- b) Predatory pricing - but none of the proposed remedies appear able to address this issue in the way that cost orientation would;
- c) Margin squeeze - but the ability of competitors to bring any such issues for resolution would be enhanced if cost accounting information were available in addition to accounting separation;

d) Cross-subsidisation - is only partially addressed by the charge control where Ofcom has been able to identify specific risks in advance;

4.26 We have identified our own list of concerns that are addressed by the cost orientation and cost accounting obligations earlier in this section together with some specific examples to show why they are not adequately addressed.

#### **Cost orientation is complementary to a charge control**

4.27 In some places Ofcom appears to characterise its decision as a choice between either a charge control or a cost orientation obligation. In practice these two remedies are complementary and Ofcom has used them as such in these markets, and many other markets, for many years.

#### **Greater price certainty**

4.28 Ofcom consider their proposed controls give rise to greater certainty however as we have previously shown very significant variations in price, including prices above or below expected LRIC based floors and ceilings, can exist under the proposed controls. Therefore we consider that properly functioning cost orientation and cost accounting obligations can only improve price certainty. We are aware of no reason, and Ofcom has not put any forward, as to how the existence of these additional remedies would lead to less price certainty;

#### **Floors and Ceilings hard to predict**

4.29 Ofcom considers that the LRIC floors and ceilings will be harder to predict due to the significant changes expected in volumes and Ofcom's proposal to re-allocate common cost. We agree that significant changes in volume do not make predicting DSAC any easier but significant changes in volumes are not new in regulated markets, significant growth was expected in the AI market in the last review and yet cost orientation was considered appropriate. In fact since then BT has changed its approach to allocating common costs and significantly widened the range between floors and ceilings making the task of setting a compliant price easier.

4.30 In any event Ofcom considers the attempts BT has made to be compliant in any investigation of compliance with the cost orientation obligation and therefore if a truly unexpected change did happen it could be taken into account.

#### **Sub-baskets and sub-caps further constrain excessive charging**

4.31 We agree that baskets and sub-caps do provide further constraint against excessive charging of individual charges but as we set out in paragraphs 4.12 to 4.15 they still have significant limitations. Under the proposed charge control it is still possible for charges to exceed DSAC during this control and the additional constraints proposed are only as good as Ofcom's ability to predict the specific risks in advance.

### **Cost Orientation: A Proportionate obligation**

- 4.32 We would like to tackle head on the notion that cost orientation and cost accounting are somehow disproportionate obligations. These wholesale leased line markets are some of the most important markets for the whole of our industry, not only to support retail services sold directly to the UK's business and public sector but they also underpin consumer broadband and the entire market for mobile services through backhaul products. These are services that are dependent upon enduring bottleneck assets where in the medium term the prospect of effective competition only exists at the margins. So why might it be disproportionate to retain them?
- 4.33 Firstly we consider the cost orientation obligation itself and whether the various competition concerns identified by Ofcom that cost orientation can help address are real. Quite clearly they are; in this response we identify several examples of the real life concerns we face as a Communications Provider that is both a customer of, and a competitor to, BT. However the most significant examples are the various disputes that have recently been before Ofcom or are still before them. In 2009 Ofcom found BT had overcharged its customers by £42m for PPC 2Mbit/s trunk. Then in 2012 Ofcom has issued various draft and provisional determinations that show significant overcharging in both PPC high bandwidth services and Ethernet WES and BES services. In many instances within these most recent disputes the overcharging occurred whilst the services were also the subject of RPI-X charge controls including various sub-caps that Ofcom put in place in 2009 in an attempt to provide additional constraints in the areas it then considered to be at risk.
- 4.34 In addition to these clear examples of the importance and relevance of the cost orientation obligation we also note that Ofcom has and continues to consider it proportionate in many other markets including markets where charge controls are in place. Although Ofcom has removed cost orientation on some specific services where it no longer considers them to be a useful constraint, or the charges are already subject to a specific cap, it has continued to use the obligation where wide control baskets are in place as well as for services outside of the charge controls themselves.
- 4.35 Secondly, we consider whether the cost accounting obligations are also proportionate. The cost information provided under this obligation is a fundamental part of Ofcom's regulatory framework. Not only does it help provide Communications Providers with information that they can use to assess potential competition problems but it is a fundamental part of the process Ofcom uses for setting charges. Unless we are to abandon the objective of attempting to ensure individual charges are aligned with cost – with what we would suggest would be disastrous consequences for both competition and efficiency – access to reliable cost information is essential. However recent years are littered with discoveries of inaccuracies with BT's regulatory financial information<sup>6</sup>. Each time a problem is found it provides an opportunity

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<sup>6</sup> For example in 2007 Ofcom uncovered various differences between revenues in the RFS compared with the management accounts which included problems matching cost and revenue in paper called 'Replicability and the PPC Charging Model'. In 2008 BT restated its regulatory financial statements giving rise to significant changes in volumes and revenues. In 2009 CWW's appeal of the LLCC found that BT's estimate of Point of Handover costs used by Ofcom had significantly exceeded true costs.

to improve the quality of the information but that will only be achieved if the information is used on a regular basis by both Ofcom and Communications Providers. Ofcom quite clearly considers that it is proportionate to impose a charge control remedy on BT and in our view the requirement to report cost information is an essential part of that.

#### **Policy project is the correct place for this decision**

- 4.36 Leaving aside the sound economic and consumer welfare arguments for continuing with the cost orientation obligation in these specific markets, Ofcom has recently embarked upon a generic policy project focused on this very issue following extensive lobbying from both BT and other Communications Providers.
- 4.37 The review started properly in November 2011 with a call for inputs and we understand that a consultation on the issues raised and the options under consideration is due in the near future. Cable&Wireless Worldwide has consistently argued for this project; we consider it of utmost importance and we look forward to the debate on this issue.
- 4.38 We believe this the correct approach to deal with this issue – to undertake a proper consultation that can consider it over the many different markets where the obligations are currently in use. Indeed this is the approach Ofcom has taken on other issues such as BT's Pension contributions and Cost of Capital. In particular having started the process we consider it is wrong to take such a significant decision as this without taking into consideration the findings from that review. In doing so Ofcom risks pre-empting the outcome of the consultation, undermining its integrity before it has even properly begun and leaves its policy decision on remedies in this market review vulnerable to challenge.
- 4.39 Ofcom's approach to the order of reaching a conclusion has strong parallels to HM Government's decision to modify the solar feed-in tariff structure early and ahead of the conclusion of the actual consultation on the issue. In that case both the Court of Appeal and Supreme Court upheld the challenge to the change, citing the lack of consultation as key reason for preventing HM Government from modifying the scheme at the earliest opportunity.

#### **THE CORRECT WAY FORWARD**

- 4.40 It is clear from the evidence set out above that cost orientation obligations and charge controls have differing functions that work together to tackle the complex and numerous issues that arise from BT's SMP. There is overwhelming evidence to retain both remedies.
- 4.41 That does not mean the cost orientation and cost accounting remedies are perfect; both BT and competing Communications Providers have their own perspectives on what works and what does not. Ofcom already has an active project to consider the issues thoroughly and that project will be able to consider whether the existing approach continues to be appropriate, or

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In 2011 BT made further changes to its cost allocation methodologies shifting significant common costs between markets because it believed an alternative methodology was more appropriate.

whether it should be modified or replaced with a different approach altogether. That is the correct place to consider these issues.

- 4.42 In the meantime Ofcom should retain the cost orientation and cost accounting obligations in both the TI and AI markets. If the policy project identifies that an alternative approach is more appropriate then that approach can be taken into account either through updated guidance or by amending the obligations in the future. Unless there are other compelling reasons that have not yet been advanced we do not see that the removal of these obligations could be consistent with Ofcom's duties.
- 4.43 However should Ofcom proceed with its proposal<sup>7</sup> not to impose the cost orientation obligation on services subject to a charge control then there are a number of steps that we believe should be taken to mitigate the adverse effects:
- a) The cost accounting obligation should be retained. At the very minimum FAC cost information should be provided on an annual basis in support of requirement to set future charge controls and ensure individual prices are reasonably aligned with cost;
  - b) All starting charges should be reviewed and the sub-baskets and sub-caps should be made tighter in order to ensure that the risk of prices being set too high or too low is significantly reduced;
  - c) The obligation to provide service on a fair and reasonable basis should explicitly include the charges that any service is supplied on in order that Communications Providers have the ability to challenge individual charges and Ofcom should make clear that it is prepared to consider such challenges even where compliance with the charge control is achieved; and
  - d) Cost Orientation should still be retained on services not covered by the charge control unless specific alternative constraints exist.

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<sup>7</sup> For the avoidance of doubt we do not consider this to be an adequate solution on the evidence we have seen to date.

## 5 MIGRATION OPTIONS

### INTRODUCTION TO THE ISSUE

- 5.1 In our response to the Call for Inputs, we highlighted that migration was an issue relevant to the Market Review process. We firmly believe that to be the case and see Ofcom's ability to facilitate a pragmatic and pro-competition approach to migration as pivotal to the success of this market review. In a market as crucial as this one it is imperative that everything is done to smooth the way for consumers to switch technologies, migrating away from legacy services in a coherent and properly managed way. As it stands the status quo does not deliver for consumers and the issue is fast descending into one where competitive distortion is a very real occurrence, with the current discord favouring BT self-provision, potentially leading to many consumers drifting back to BT to ensure their individual migration journey is as smooth as possible. Ofcom should not underestimate the commercial opportunity that migration discord presents BT's lines of business, and while the Undertakings provide some protection, they were not written with the current migration minefield in mind.
- 5.2 It is our view that BT is currently able to enjoy the benefits of lower cost services far faster than CPs are able to, largely as a result of the different requirements BT and CPs have for migration. We believe that BT is actively impeding availability of the migration options that CPs need in order to pursue revenue maximising strategies.
- 5.3 Ofcom needs to be alert to this issue and recognise that significant effort is now required to remedy the situation to prevent consumer harm. In the residential consumer market Ofcom have devoted a considerable amount of resource in the switching arena. While this issue is undoubtedly more specialist and is not focused on switching between suppliers, rather it is about switching between technologies, it is a market of considerable value and an extremely important issue to the consumers who make use of connectivity services, with many businesses left dismayed at just how problematic and expensive connectivity migration can become, often viewing it rightly as too costly and left surprised by the lack of a coherent industry approach to managing the process.
- 5.4 The issue of migration requires Ofcom's focus to ensure an equitable outcome, one where all communication providers can respond effectively to meet the needs of their customers when migrating to new technologies. Finding the correct approach to migration is going to take some time, time that isn't available in this market review consultation process. We therefore believe it would be beneficial to carve out the issue of migration from this review and deal with it within the context of a self-contained consultation on the issue, ideally immediately following the conclusion of the BCMR.
- 5.5 Dealing with it within the current consultation doesn't allow the issue to be addressed in sufficient detail and we risk tweaking the status quo, with the result that nothing material changes and consumers are left with an unsatisfactory outcome that lends itself towards sourcing their connectivity solution from a BT group source in order to secure as smooth a

transition as possible. Doing nothing on migration is not an option at this stage in product lifecycles, with so many products reaching end of life within the next review period Ofcom cannot preside over an outcome where consumers find themselves backed into a corner with their communication supplier having few if any tools at their disposal to accomplish a smooth migration.

#### **FOCUS OF A FUTURE MIGRATION CONSULTATION**

- 5.6 The scope of a future Ofcom consultation should aim to address two key issues:
- a) Satisfying the immediate migration needs of consumers by trying to improve the options available to those who require to migrate.
  - b) It would also be a missed opportunity if the consultation were not to discuss future proofing the process to prevent a recurrence of this kind of situation. Thus ensuring that any new connectivity products are launched in the years ahead within a framework that considers migration need at the outset, not as an afterthought.
- 5.7 In the context of addressing the pressing need for migration solutions today, we can categorise consumer need into two distinct areas:
- a) Migration away from legacy WES to EAD and EAD LA; and
  - b) Migration away from TI. TI has a large installed base being the legacy BCMR service;
- 5.8 Presently the migration process in particular for legacy WES discriminates in BT's favour. We'll address each of these demand categories in turn below.

#### **MIGRATION FROM WES– THE CURRENT PROCESS ISN'T DELIVERING**

- 5.9 In the situation of Ethernet services, we consider that BT and CPs are facing differing migration requirements which are reflected in the migration products that BT is making available. Ofcom has observed within the BCMR that CPs are increasingly investing in local exchange presence to take up the Local Access ("LA") product option. This is in response to BT's own adoption of LA services, BT being the first mover.
- 5.10 Interestingly, the first WES migration offer was a paper reclassification offer allowing WES services to migrate to WES LA. This offer allowed BT to reclassify its WES services at the relevant exchanges to be LA services at minimal cost.
- 5.11 CPs however were not able to utilise the WES migration / reclassification offer. As for CPs the process is more complicated, with WES services typically handed over at a CP Point of Presence rather than a BT local exchange. Therefore in order to convert a WES service to EAD LA (or WES LA) a CP must move the circuit handover end to the local exchange. Paper migration is not an option.
- 5.12 In practise this means that CPs use their LA presence in order to connect new services but legacy services remain provided in the old manner.

- 5.13 What this ultimately means is that CPs have a unique requirement when migrating from legacy WES services to EAD services. CPs, in addition to the migration options that BT has launched to date, also need the option to switch from WES to EAD LA.
- 5.14 As discussed above BT does not have the same incentive to develop this requirement as a large part of its own WES to WES LA migration will have occurred through paper migrations and therefore BT simply needs to migrate WES services to its direct opposite EAD service.
- 5.15 BT is not blind to CPs requirements as is evidenced in the BT originated SoR 8159 of January 2011. This SoR captured the migration requirements of industry including the requirement to migrate non LA legacy Ethernet services to EAD LA.
- 5.16 Since then BT has offered migration that converts legacy Ethernet to EAD at a higher bandwidth (without a move to LA option). BT is about to offer migration of like for like services (without a move to LA option). BT has now announced that the ability for CPs to migrate legacy WES to EAD LA has been discounted as this is not commercially viable for BT.
- 5.17 Consequently CPs are left without a migration process to support the migration to LA. CPs wanting to undertake this type of migration incur the full new connection charges, ECCs, parallel running costs and early termination costs of the legacy service as well as significant costs within their own business to manage the re-arrangement. We consider the situation to be discriminatory and untenable.
- 5.18 We would like to see a future consultation deal with this issue as quickly as possible, as the increased costs that CPs are facing absent the ability to migrate to the cheapest and optimal solution and in view of the planning required to migrate circuits swiftly in advance of platform closure is a real commercial handicap that needs to be addressed.
- 5.19 In any future consultation Ofcom should give careful thought to the issue of how to treat connection costs, particularly in cases where the legacy services are still provided within minimum contract terms, terms that were typically agreed without the full knowledge that a successor product was likely to be available during the term or that a platform would be closed. Such contractual penalties while sensible in periods of product continuity become anti-competitive in a legacy product context and should not be used as an artificial restraint to prevent CPs migrating particular customers. We have no doubt that in such circumstance a sensible solution can be found that ensure BT is not disadvantaged, while the CPs aren't forced to maintain customers on legacy products longer than necessary. The consultation should examine what offers Openreach has made in the past (largely taken up by BT's lines of business) and seek to replicate these for external purchasers based on the next generation of product variants they actually consume (as previous offers to discount or waive connection costs have been focused on products that aren't attractive to many CPs).

## MIGRATION AWAY FROM TI

5.20 It is clear that a large volume of customers who currently use TI services that will at some point require to be migrated to AI or other services. While we recognise that such a migration involves moving from one delivery platform to another, there are without doubt synergies in the provisioning of the circuits, including the entry into the serviced premises that are being ignored. There is an urgent need for an effective process to be established which recognises both the old and new circuit, linking the provisioning and cease activities within a service wrap that minimises cost and maximises customer experience. The current disharmony provides BT with a significant revenue stream and hampers retail competition. We are aware the AI services are provided by Openreach and TI services are typically provided by BT Wholesale and there is need to respect the integrity of the Undertakings in any process, but the Undertakings shouldn't be a block to improving the process and we have no doubt that with willing on all sides a sensible TI to AI process can be developed. A future migrations consultation is the ideal place to reach a conclusion on what can be realistically achieved to enhance the consumer experience in the transition from TI to AI.

### **Future proofing: Migration as an inbuilt solution for new services**

5.21 Service migration represents significant cost for CPs, and ultimately end users. The current set up lacks integrated planning and business orientation, being very much an afterthought – a bolt on. This often means that migration is conducted in a very inefficiently way. Generally it involves a costly process of parallel running of the old and new service and subsequent cease of the old service once the new installation is proven to work. CPs/ end users can face the following charges from BT for the migration:

- a) new installation charges,
- b) ECCs,
- c) equipment to host the duplicate circuit,
- d) BT Project Services,
- e) Early contract termination,

On top of these external costs CPs incur their own internal planning and rearrangement costs.

5.22 With migration from legacy services becoming a more frequent occurrence as technology advances become more rapid, we believe the current situation isn't sustainable with some radical changes needed to help ensure that migration needs are at the front and centre of future product development in instances where the product being designed is envisaged as being a direct replacement for an existing product. To that end Ofcom should consider placing an obligation upon BT to offer fair and reasonable network access that can be enforced (with clear justification) to include a requirement to offer reasonable migration solutions.

- 5.23 That would result in Ofcom requiring BT to simultaneously offer business orientated migration processes / commercial wrap for existing services which CP's may wish to migrate from<sup>8</sup> when successor products are launched. For example under such a regime, when it launched EAD BT would have simultaneously launched the migration package for legacy WES to EAD migration. The EAD migration offer would include specifications of the process and if relevant any commercial wrap.
- 5.24 The desired result is a professionally managed migration plan that enables efficient migration. We consider that in the long term this will lead to a more efficient industry and a more competitive industry and therefore will be beneficial to end users and UK Business.
- 5.25 It would also be worthwhile for any future consultation to consider what, if any, additional requirements may be needed to facilitate switching between alternative suppliers at a wholesale level as it may prove necessary to modify generic access obligations to consider the migration of services between providers.

#### **SUMMARY ON MIGRATION**

- 5.26 A standalone consultation into this neglected but crucially important issue would allow Ofcom to strike the right balance, delivering an outcome that is derived from a sensible consideration of what is practically achievable, technically possible and commercially desirable, set against the backdrop of very real consumer need. We recognise that migrations are always difficult and we have realistic expectations of what can be achieved. While we know that a solution cannot be found for every consumer in every situation, there are a great many consumers who face very similar migration headaches and some relatively straightforward changes to process, approach and commercials would provide considerable benefits. Above all however, Ofcom need to make changes to ensure that other Communication Providers can provide the same migration experience and solution options as internal BT lines of business, creating a truly level playing field. Unless this is achieved Ofcom will have failed as even if the smallest of competitive distortion persists it will very likely give rise to a far wider gap in consumer perception when contrasting BT's competency to manage migration with that of other suppliers, leading to BT winning business purely as a result of that competitive distortion.

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<sup>8</sup> Of course this will require detailed qualification following the BCMR conclusions.

## **6 FOSTERING FURTHER COMPETITION IN BCMR MARKETS (DEPTH OF INTERCONNECTION)**

- 6.1 Ofcom does not consider that BT has SMP in the provision of AI trunk or core conveyance. Competing Communications Providers can purchase the regulated inputs such as EAD and EAD LA from Openreach and self-provide their core networks. We agree with this analysis. However we do not consider that this alone is sufficient to ensure effective competition in retail and intermediate wholesale markets.
- 6.2 In the period since the last market review there has been a significant increase in the purchase of 'local access' services. These local access services such as EAD LA<sup>9</sup> (we refer to them as 'LA' services) are the lowest cost input that is available in the AISBO market as they make the connection only between the local BT serving exchange and the end user. In contrast traditional EAD circuits make the connection from the end user, via at least one and maybe more<sup>10</sup> serving exchanges and then into the Communications Providers premises through a second local end. This type of circuit uses more resources in BT's network and hence costs more. Customers that wish to purchase the lower cost LA version must build a presence in the local exchange with appropriate backhaul capacity and where the volumes are sufficient the cost of this is outweighed by the saving from the lower cost LA products. It makes sound economic sense.
- 6.3 BT has already taken advantage of this, as the first mover, and now other Communications Providers have made the investment too. Economies of scale and scope are fundamental to the investment case. We think this can work well for the largest of BT's exchanges; in a similar way that LLU provides competition in the WBA market for much of the UK and in turn there is strong competition in retail broadband. The problem arises if too few operators can justify the investment to pick up the LA service, but BT, with its ubiquitous network and its scale and scope, can reap the rewards of its position without effective competition. Unlike in consumer broadband, business connectivity is a nationwide service as customers need a supplier who can connect all their locations.
- 6.4 Our recent experience in this market is that BT's position has become difficult to compete with. While we invest to catch up BT can go further. Its scale and existing network will give it the advantage and without some constraint we foresee the need for geographic regulation of BT Wholesale in order to ensure that effective competition in retail markets can be maintained. That is not an outcome we think is either necessary or desirable.
- 6.5 The technical constraints of fibre are far less significant than for copper and that means there is no need to push competing operators to build out to the vast majority of BT's 5500 local exchanges in order to take service. In less densely populated areas it is sensible to allow the

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<sup>9</sup> Also WES LA although its use will be phased out over the next market review period

<sup>10</sup> Where main link is involved

lowest cost regulated input to be routed over a longer distance in order to drive consolidate demand into fewer handover locations.

- 6.6 At the heart of this issue is the importance of CPs having equal opportunity to achieve optimal economies of scope and scale. In the run up to the market review BT requested an exemption for EoI in relation to very high bandwidth services. CPs including Cable&Wireless Worldwide are extremely concerned that BT has been favouring itself in the provision, in particular, of very high bandwidth backhaul services. It is acknowledged that incremental wavelengths on WDM equipment have low incremental cost. Therefore the cost and price margin between say 1G and 10G is not 1x10, similarly between 10G and 40G. In February 2012 CWW provided Ofcom with a paper setting out what it considered as network competition issues arising across BCMR and NGA markets. Within this response we elaborate upon these competitive issues, their effect and possible solutions.
- 6.7 It is established that where multiple services share backhaul connections/capacity<sup>11</sup> economies of scope are optimised. Many end users and services share, for example, a 40G backhaul circuit resulting in far lower per user unit costs for the backhaul than users connected via a 1G backhaul service. Similar economies of scope are achieved for the handover point (the accommodation / co-location space, and network equipment required at the BT exchange).
- 6.8 It is CPs understanding that BT Operate runs on behalf of BT LoBs very high backhaul connections lowering and sharing the unit cost between the BT LoB. In order for CPs to be able to replicate such costs it is important that many services can share the backhaul connection. In order for a CPs to achieve this there are two requirements 1) that handover points are permitted and capable of aggregating many different types of services in order to drive scale backhaul from that point and 2) in order to drive that scale that the number and location of handover points for different services (across regulated markets) is managed (or constrained) such as to facilitate CPs achieve scale at these locations.
- 6.9 To some degree this has been acknowledged with historic consideration to allowing equipment sharing between PPC and PSTN services at the PoH and it is the case that Access Locate upgrades the space that is made available for LLU services to allow sharing of this space and network and indeed backhaul by LLU and Ethernet services.
- 6.10 As we look forward we identify the crucial requirement to achieve efficient economies of scope in particular in the “collection” of services from BT and in the backhauling of the collected services to our core network nodes.
- 6.11 Ofcom itself in the BCMR remarks upon economies of scale and scope when conducting its analysis on each of the markets it proposes to determine. Ofcom reflects that BT benefits from the relative scale and scope of its operations across connectivity markets and fixed markets.

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<sup>11</sup> Where the backhaul demand of a number of services such as AI, WLA (LLU and NGA) can be aggregated into a single backhaul circuit

When referring to scope we believe Ofcom means the number of different services BT is engaged in offering.

- 6.12 Ofcom also notes significant mergers and acquisitions, which include Cable&Wireless Worldwide purchasing Bulldog, Energis, the Thus Group (incorporating Your Communications), and Vodafone's most recent acquisition of Cable&Wireless Worldwide itself. Global Crossing acquired Fibrenet and then merged with Level 3. TalkTalk acquired Tiscali. We consider these mergers and acquisitions are a reflection of the economies of scale and scope that are required in order to remain competitive within telecoms markets. Crucially we consider mergers involving companies focused more on WLA and WBA markets just as relevant because BT derives its economies of scope and scale across all these markets.
- 6.13 When seeking to remove the network inefficiency that is typically present in legacy services and legacy networks which overlaid and replicated one another, modern communication protocols and transmission have been designed to allow CPs to remove unnecessary network duplication and permit sharing of network nodes and transmission. Theoretically this should enhance the economies of scope that CPs can achieve.
- 6.14 BT has complete freedom in its ability to maximise its own economies of scope. CPs relying upon BT for bottleneck services often have their opportunities for economies of scope diminished as BT's network design is targeted to benefit BT with handover points and backhaul points suited to BT's scale and convenience rather than CPs. Whilst providing regulated access to key access services, the silo market approach to regulation results in network inefficiencies for CPs, which place CPs at the competitive disadvantage to BT. Until very recently each regulated service has required its own handover interface – a cost and complexity that BT does not face. The number and location of handover points continues to diverge between various regulated services. We consider that regulatory oversight around this is warranted.
- 6.15 The regulatory environment encourages investment and competition through the way it requires access to bottleneck services. In practice many of the details are left to BT and it is often BT that decides where an operator has to interconnect in order to get access to the lowest cost service.
- 6.16 Ofcom has acknowledge the barrier this represents (by requiring the availability of Access Locate which allows sharing of LLU and Ethernet handover points, and proposing EOI for space allocation as part of this review) and the additional cost burden that this imposes by setting PPC PoH charges at their LRIC.
- 6.17 These are all important but rather incremental steps. CPs continually need to invest: going to local exchange to take up LLU services, going to the local exchange to be able to benefit from Ethernet local access pricing, going to the local exchange to pick up NGA services.
- 6.18 When considering where to situate these services or the number of sites required to go to, BT suits itself. We consider that this is wrong and that BT should be required to locate handover points for incremental services in a manner which will equally benefit CP's economies of scope.

- 6.19 CPs are saddled with BT's costs of product development and rollout within the charges they pay but much of the time this includes costs which do not benefit CPs. Take for example BT's Orchid EBD rollout, highly heralded as BT's move to 21CN network. This EBD network is of little value to CPs as it has been designed to BT's locational requirements. Looking forward to NGA – which can be picked up using the Access Locate hand over product – it is important that the handover locations are in places where CPs already have a handover presence, or could efficiently extend their networks due to the demands of other services.
- 6.20 We consider that the proposed NGA handover location list of 1090 exchanges projected for 2015 represents an economic boundary beyond which further efficient handover deployment could not be warranted. As such development of handover points for all markets whether existing services and new services should be confined to these points<sup>12</sup>. The point and benefit of this exercise is to allow CPs to achieve and enjoy economies of scale and scope more akin to BT and to remove cost barriers unnecessarily put in place by regulation.
- 6.21 In doing this we must not consider different networks in isolation. Although for regulatory purposes Ofcom must consider each market<sup>13</sup> distinctly in practice the economies of scale involved in infrastructure investment make it essential that demand from all different markets is combined when it comes to the justification for, and efficiency of, any investment.
- 6.22 In the context of the Business Connectivity Market Review Ofcom has recently asked industry for its views on the different levels of interconnect for Ethernet services.
- 6.23 At present theoretically EAD LA could be bought from any local exchange. The definition of LA being that it is handed over at the first serving exchange. The problem is that there are 5500 exchanges<sup>14</sup> and BT's scale and scope means it is able to justify more of these exchanges than anyone else. BT has already built to a market leading position for LA coverage and that gives BT a cost position that most other communications providers are struggling to compete with. The LA product is presently provided to a specification designed by BT. However for BT, the decision about where the interconnect takes place has relatively little impact upon its own business because of its ubiquitous network, but it is much more significant for BT's competitors. Competitors have to invest in backhaul connectivity to the local exchange, invest in accommodation / co-location space and also in equipment in order to connect the LA service to the backhaul supply.
- 6.24 Cable&Wireless Worldwide believes there are strong policy reasons for limiting the number of locations that Communications Providers must interconnect at in order to get access to the lowest cost regulated inputs. If this is done correctly it will encourage investment in the AI market and drive stronger competition to the benefit of end users; without it we risk competition

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<sup>12</sup> With the exception of LLU and SLU which of course have technology limitations

<sup>13</sup> such as AISBO (alternative interface or ethernet), TISBO (traditional interface of SDH and TDM) and WLA (LLU based copper access and next generation access)

<sup>14</sup> Although only a subset of these will have material demand for point to point business connectivity services it is still a set of exchanges that very few operators are likely to be able to justify connections too.

problems in downstream markets requiring further regulation. We also believe this should be done in a way that ensures the same locations are used for VULA and EAD LA. We propose two potential alternative solutions that Ofcom could readily adopt when concluding the BCMR.

#### **Define a list of LA exchanges and average out LA charges**

6.25 This list would determine the exchanges at which a CP would need to be present in order to be able to purchase EAD LA from. The rules of the LA product would be changed so that there would be a shorter list of parent exchanges<sup>15</sup> by grouping several exchanges with low demand and close proximity together nominating one as the parent. This would mean that a proportion of LA circuits would be longer than the present length as they would extend beyond their first serving exchange onto their parent exchange. This is relatively similar to the situation for NGA where smaller exchanges are parented onto larger handover hubs. A consequence of including a proportion of longer length circuits into the general pool of LA services is that the average cost of LA services may need to rise marginally. We consider that the ability to create larger backhaul hubs at fewer locations makes a modest increase in LA prices worthwhile. We consider that Ofcom could adopt this approach by issuing a direction requiring BT to nominate LA exchange locations and the parenting of smaller exchanges with these. Ofcom should include a requirement upon BT to ensure that maximum correspondence between LA exchanges and NGA handover points is achieved.

#### **Make available EAD LA with an additional per meter component**

6.26 The difference between an EAD circuit and an EAD LA circuit is that the EAD circuit has two local ends included within its price. It is the additional local end which makes the EAD circuit significantly more expensive. We have discussed previously that in smaller exchange locations CPs will not be able to justify the extension of their LA presence. An alternative solution to the one identified above would be to enhance the LA product to include a per meter additional charge (payable between the serving exchange and the subsequent handover exchange at which it terminates). Whilst this option has the benefit of ensuring that all circuits are cost reflective it has the downside being applicable in all areas, even those where investment in today's LA product is viable. As a result it runs the risk of network inefficiency through the use of additional fibre usage i.e. if it were used to "long line" LA circuits and avoid connection at all of the major LA parent exchanges as identified under option 1.

### **LOOKING TO THE FUTURE**

6.27 Is there a role for the OTA to mediate between BT and CPs in order to have common agreement on the location and number of handover points for a given service? Considerate planning in this manner will not doubt improve cross portfolio efficiencies by BT, improve the CPs cost base by eliminating unnecessary duplication, potentially take the strain off BT's space

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<sup>15</sup> Fewer than the approx. 5500 there are today

resources as CPs can plan ahead rather than incrementally order space service and ultimately benefit the consumer with more highly fought over price competition for services as CP are able to compete away the economies of scope they derive.

## 7 MISBO REGULATION PRICE CERTAINTY

- 7.1 Cable & Wireless Worldwide welcomes Ofcom's decision to regulate MISBO services. As we suspected the evidence has borne out that BT has SMP within this important and growing market. It has been evident that Ofcom has understood the importance of MISBO services - in particular the use of MISBO for backhaul. Indeed this was reflected in Ofcom's decision to exclude very high bandwidth backhaul services from the consultation initiated in response to BT's request for a waiver for MISBO services conducted in 2011, in advance of the BCMR consultation.
- 7.2 Whilst we welcome the SMP finding and the proposed regulatory remedies such as EOI, we have serious concerns about the decision not to impose a cost orientation obligation and to only charge control single interface MISBO services – which we understand to be only WES and BES 2.5G. This decision needs to be urgently reviewed in light of the fact that since the BCMR consultation commenced, BT has presented proposals to withdrawal these legacy service.
- 7.3 In all likelihood the bulk of CP demand will move to OSA based solutions (which are more flexible for CP requirements) and it is imperative that any remedies are focused on the future product set, not the legacy one. If Ofcom don't widen the scope to include OSA, then the remedies proposed would become largely academic and would not address the significant bottleneck issues which arise from BT's market power in MISBO.
- 7.4 In setting remedies in this market Ofcom need to be mindful of BT's flexibility to load costs to suit its own commercial ends. There is a significant variation in the purchasing demands from BT's own lines of businesses for MISBO services and that of external purchasers. During the early phases of the last review BT rolled out the Orchid / EBD network, this is BT's backhaul network designed to backhaul BT's services between its ASNs. CPs are also able to purchase these services but as it was designed with BT's own network in mind, CPs are finding that it often fails to meet their requirements. Consequently CPs have concentrated on the OSA product which is better suited for CP backhaul. With a large amount of common cost between all MISBO products (& OSA and EBD in particular) BT must not be afforded any opportunity to load costs on the products favoured by external customers and in so doing keeping the products it consumes itself less expensive.
- 7.5 If such an outcome were to transpire it is highly likely that BT would utilise that lower cost base to win market share in the commercial backhaul market and in particular the hugely significant mobile backhaul market as it moves into a 4<sup>th</sup> generation technology world. Without the appropriate remedies in place it is entirely rational for BT to behave in this way, maximising profit both in the MISBO market but also leveraging their artificially low cost base to win business beyond the wholesale market.
- 7.6 It is clear that EOI obligations alone are insufficient to address the problem and while we fully understand Ofcom's reluctance to charge control MISBO, we believe the imposition of a cost orientation remedy strikes the correct balance. Preventing BT from mis-apportioning costs,

guarding against excessive pricing and giving a degree of price certainty over the period of the market review.

- 7.7 If Ofcom press ahead with their proposals for MISBO unaltered then we fully expect that more onerous and interventionist remedies will be required in three years time as Ofcom attempts to rein back BT's enduring market power, something that is far more challenging to accomplish particularly when BT has been afforded the opportunity to entrench its market position during a key phase of market development.

## 8 TRUNK MARKET ANALYSIS

- 8.1 Ofcom proposes to find two distinct markets for traditional interface trunk services. A market for regional trunk and a market for national trunk. Cable&Wireless Worldwide disagrees that these separate markets exist today.
- 8.2 PPCs are in the later stages in their product lifecycle with a number of newer technology / product options for customer requiring PPC equivalent bandwidths. Customers are not actively taking up new PPC supply in any volume. Although there are some large end users that require the particular service characteristics of PPCs the majority of end users together with their Communications Providers will be considering plans for the migration to newer technologies. It will take some time. The speed and timing of this will depend upon the contract term outstanding and of equal importance the customer's budget cycle and funding to enable it to undertake a major communications upgrade programme. However, the priority for investment will be to migrate to a new solution rather than invest in the old.
- 8.3 We consider that Ofcom's conclusions that the proposed national trunk market has greater prospects for competition do not bear out against our market knowledge of customer and CP behaviour.
- 8.4 From the consultation document it is unclear whether Ofcom has been able to compare the market share of the "national" trunk market as proposed between the two review periods ie what it was at 2008 compared to the 45 – 49% that Ofcom now concludes is BT's market share. We consider that the relative change of share across the overall market and proposed markets will be a useful indicator.
- 8.5 However, even if BT's market share of the proposed national trunk market has fallen over the period in comparison to CPs own supply of trunk in this market it does not necessarily correlate that this is due to CPs switching national trunk usage between suppliers. It may be the case that CPs have targeted PPC circuits with a costly heavy reliance on BT's (national) trunk provision to be circuits that they have migrated to alternative services as a priority. End users provisioned on this type of circuit will be far more cost sensitive when weighing up the benefits of moving to potential substitute services.
- 8.6 We consider that a more in-depth analysis looking at customer (end user) planned behaviour will demonstrate to Ofcom that determining part of the trunk market to have greater prospects for competition is a false premise.
- 8.7 We consider that prior to concluding that a national trunk market has the prospects for greater competition Ofcom should consider the availability of a merchant market and the likelihood that the prospect of additional national trunk sales would prove an attractive option for such suppliers. Cable&Wireless Worldwide certainly does not wish to engage in additional investment in national trunk to meet such as short term market need.

- 8.8 We continue to view the PPC trunk market as a single market. We consider that the competitive conditions across Ofcom's proposed national and trunk market do not vary sufficiently to warrant the designation of two markets. We consider that BT has SMP in trunk supply.
- 8.9 We have sought to understand the impact of Ofcom's proposal on the PPC trunk that we purchase today. We purchase PPCs using a large number of points of handover in all areas of the UK and would not have expected to purchase much national trunk. In fact our analysis shows that we purchase a significant quantity of what Ofcom would call national trunk.
- 8.10 Further analysis of these requirements shows a wide range of routes. We have explained in various previous submissions that actual circuit routing is heavily influenced by a variety of factors including historic constraints, the requirement for resilience and diversity and the specific location of platforms to which circuits are routed, particularly in the DPCN network where routing is constrained by a limited number of DPCN nodes. As a result it is perhaps unsurprising that circuits might be routed between cities such as Liverpool and Manchester or within the London region. Although today we may have various other theoretical routing options that could provide the resilience our customers require, it is certainly not easy to say a routing of this nature was a bad choice when it was made, nor that it is a good use of our resources to re-visit it now.
- 8.11 We have explained above that we consider the trunk market to be national, and that BT has SMP in that national market. We agree with Ofcom that it is logical to expect the potential for competition in a 'national' element of that market, but in our view the stage in the lifecycle of PPCs means now is not the time to try and promote that further competition. However if Ofcom does maintain its view that there are two trunk markets then we believe it should adopt a wider definition of 'regional trunk'
- 8.12 Taking one of our examples above, why would there be any reason to think that the potential for competition on the Liverpool to Manchester route would be any different from that on the Manchester to Sheffield route? Under the current proposals the former is national trunk but the latter regional. The Greater London region in particular appears to have a number of such routes that cannot really be considered to be 'national.'
- 8.13 We suggest the following amendments:
- a) In Greater London all routes between those TANs and those adjacent to Greater London are all considered 'regional'. That means routes between London Central, London West, London East, London North, London Docklands, Kingston and Croydon are all regional but also between any of those TANs and those adjacent to the Greater London area – Guilford, Slough, Watford, Luton, Bishops Stortford, Chelmsford and Crawley.
  - b) Elsewhere the routes between Liverpool and Manchester and between Edinburgh and Irvine are regional.

## 9 ANSWERS TO BCMR QUESTIONS

### ***Question 1: Do you agree with our approach to retail market definition and our proposed retail product market definition?***

- 9.1 Ofcom proposes a retail market definition which is largely the same as the BCMR 2008 findings, the exception being the finding of the very high bandwidth / MISBO market. We agree with these conclusions.

### ***Question 2: Do you agree with our approach to wholesale product market definition and our proposed wholesale product market definitions? In particular, do you agree with our proposal to define a Multiple Interface Symmetric Broadband Origination (MISBO) market?***

- 9.2 Ofcom analyses wholesale product market definition under the heading of five issues. We follow that format in giving our views.

#### **Alternative and traditional interfaces**

- 9.3 We agree that separate markets for AI and TI exist. We agree with the inclusion of RBS within the TI market and with Ethernet services that support mobile backhaul such as SyncE being in the AI market.

#### **Very high bandwidth leased lines services**

- 9.4 Ofcom proposes to find a new market for MISBO. We discuss the MISBO market in section 7. In summary we concur with Ofcom findings that the MISBO market exists and that BT has SMP in the market. We do not believe the proposed remedies are sufficient to address the market power BT have in this growing market and would like to see Ofcom amend its proposals to require cost orientation and include OSA within the scope of any remedy. We address BT's exception request for MISBO within WECLA within our separate response on the matter.

#### **Wholesale access and backhaul markets**

- 9.5 Ofcom proposes that separate access and backhaul markets do not exist. Our concerns regarding access to equivalent backhaul products to BT leaves us concerned that Ofcom's analysis does not capture some of the specific differences relating to demand and supply for access and backhaul sufficiently.
- 9.6 For its own backhaul requirement BT has developed EBD. Communications Providers are able to purchase EBD but the fact remains that the product has been designed to match the location of BT's aggregation nodes and not CPs' networks. CPs have tended to use WES or BES for their backhaul requirements. Looking to the future CPs are considering the use of OSA to meet this need. There is therefore a divergence in the demand and supply between CPs and BT for backhaul services.

- 9.7 We discuss earlier our views on Ofcom needing to consider competition across all communications markets. Reflecting upon whether backhaul services have different competitive conditions to access looking across markets identifies that there is development of key hubs where backhaul services are required to pick up a range of communications services (from this market and from others). Ofcom considers this under the converged backhaul assessment (4.172 onward). We agree that the situation for TI and AI differ.
- 9.8 At 4.177 Ofcom hits the nail on the head:
- “the implication of converged Ethernet backhaul is that only the largest players (including BT) may be able to fully exploit these economies of scope and scale”...Due to its large scale BT would be best placed to aggregating large amounts of traffic using converged backhaul, driving down its average backhaul costs. Therefore, potentially competitors considering investment in infrastructure would have to overcome barriers associated with the ubiquity of BT’s backhaul network, but increasingly also its lower backhaul costs. So, this could potentially mean that CPs would only be able to reach the scale of traffic needed to achieve cost competition with BT in dense population centres and only some the routes between them.”*
- 9.9 What Ofcom outlines above is exactly the situation we are facing. Industry is consolidating to improve its economies of scale and in order to match the large amounts of aggregated traffic that BT can generate and the related economies of scale that result. This is at the heart of our proposal to constrain the ongoing aggregation point rollout and also to align the handover points of different services which we discuss at section 6.
- 9.10 All the major infrastructure players are refocusing their network presence to handover at the key BT local exchanges for the handover and aggregated backhaul of:
- a) LLU based inputs
  - b) EAD LA
  - c) NGA and VULA
- 9.11 We consider the assessment of access and backhaul as a single market (together with our particular factors of detail such as MISBO availability and MISBO pricing) enables BT to mask the differences between the backhaul services that are provided for itself compared to the services that CPs purchase and the consequences for competition thereof.
- 9.12 In our earlier section 6 we make proposals that Ofcom should adopt in relation to EAD LA pricing availability. This is a considerable step forward in enabling CPs to achieve cost competition.
- 9.13 Resolution of the backhaul problem due to the consequence of scale differences and the fact that CPs and BT purchase different backhaul inputs is not yet satisfactorily concluded under the MISBO proposals or the charge control proposals.

### **Symmetrical broadband origination as an input into other retail services**

- 9.14 We focus our comments under this heading on Ofcom's view that CCTV, Broadcast and Street Access are products that are outside of the BCMR market.
- 9.15 Ofcom is correct to identify these services as having niche application. These products are provided with an Ethernet input as per other AI service but specific NTE to adapt their capability. We consider the nature of these applications and the very fact that they are niche creates higher barrier to entry in comparison to AI services generically. A provider would not find it economic to enter the market solely with the view to provide these niche services.
- 9.16 The peculiar pricing differential between these services and their standard AI comparison suggests that pricing today is based on competition rather than cost orientation obligations. For example with CCTV access charges (which are competing with broadband alternatives) are particularly low. However for broadcast access circuits charges are significantly above the standard AI charges – reflecting in our view both the higher costs of the required NTE and BT's competitive position as the primary supplier.
- 9.17 Our view is that these services do fall within the AISBO market. Following on from the undertakings these services were developed because at the time the standard WES services did not quite meet some existing requirements for various reasons. That is not always the case now, for example EAD is capable of being ordered to street furniture. There is no reason why EAD cannot be used to run CCTV. It is just that BT's own business has some specific requirements and it decided to develop specific products rather than enhance WES to meet them.
- 9.18 The consultation document provides the impression that as these are low volume services that Ofcom has concluded it unnecessary to conduct the full market analysis to understand the competitive prospects for these services. We note that where we use our own fibre for CCTV, broadcast services or connecting wireless routers we include those circuits in the information we provide Ofcom, We do not distinguish between these specific uses. We consider that for the market analysis to be correct the volumes of these circuits should be included.
- 9.19 For completeness we will deal with our views on remedies here. We do not suggest there is a particular problem with pricing or availability that impacts us today. In our view the only remedies that should be in place are EOI<sup>16</sup> and the basic transparency obligations. We make no argument that they should be included within the charge control.

### **Bandwidth**

- 9.20 We agree with the conclusions that Ofcom makes.

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<sup>16</sup> These services are already EOI as a result of BT's undertakings. We would strongly object to any request for an exemption from EOI under the undertakings.

**Question 3: Do you agree with our approach to geographic market definition and our proposed geographic market definitions? In particular do you agree with our proposal to define a larger geographic market in London (the WECLA)?**

- 9.21 A key parameter within Ofcom’s approach to geographic market definition is the 200 meter dig distance. In response to the 2008/9 market review Cable&Wireless Worldwide (and indeed many other CPs) raised objection with the 200 meter assumed distance. In response to the Calls for Input Cable&Wireless Worldwide proposed that Ofcom undertake formal analysis to understand the real dig distances which CPs have undertaken. Ofcom has taken forward this proposal and Table 24 page 210 summarises the findings. Whilst there was an outlying example of 1km dig the typical distance was much shorter with the median at 22m and the average at 65m. These distances are substantially at odds with the 200m modelling assumption that Ofcom continues to deploy. Ofcom seems to use the 200m distance as it “encompasses” most digs that have proceeded ie only 6% of digs incurred were longer than 200m. Ofcom does not provide the statistic for the % of digs that 200m surpasses. Reviewing the Table it would however that some 85% plus of digs are significantly short of the 200m distance.
- 9.22 An additional factor that Ofcom brings to bear is that in the absence of regulated inputs that CPs would actually dig further distances. Ofcom does not provide any analysis of the pricing break point – at which CPs would dig further.
- 9.23 We note that at Paragraph 5.132 Ofcom acknowledges the inclusion of some postcodes which don’t meet Ofcom’s competitive criteria but are included due to the fact that they are surrounded by postcodes which do meet the criteria. Cable&Wireless Worldwide considers this approach to be erroneous. Given that Ofcom is specifying the individual postcodes which are competitive it is simple and correct to leave out the postcodes that do not meet the competitive criteria that Ofcom is using.
- 9.24 We discuss in our earlier section the importance of economies of scope within backhaul. The proposals for unregulated MISBO within the WELCA, has ramifications for the attainment of economies of scope matching BT, for services that are regulated in the WECLA area. BT doesn’t face issues of having to dilute economies of scope of its backhaul or aggregation points as CPs do. BT we presume will be permitted to share backhaul for regulated and unregulated services within WECLA whereas CPs will have regulated services and unregulated services transported over different networks and handovers increasing our costs further.
- 9.25 Designating geographic markets for BCMR services is a very different proposition to designating geographic markets for WBA services. For WBA CPs can rely upon LLU which is another BT service and exchange based which can be handed over with other regulated BT services and backhauled with other regulated services whereas for BCMR when a service is deregulated the alternative is use of the CP’s own network which has the knock on requirement for duplicate separate network and diluted economies of scope for the “competitive service” and the remaining regulated services at that location. At paragraph 2.21 Ofcom notes that BT’s new design allows BT to aggregate services efficiently, so that several leased lines and other

services can share a single optical fibre where their respective routes coincide between BT exchanges.

***Question 4: Do you agree with our approach to product and geographic market definition for wholesale trunk and do you agree with our proposed market definitions for wholesale trunk?***

- 9.26 It is fact that PPCs are legacy services. It is also fact that PPC charges for the bandwidth provided are higher than charges for comparable bandwidths of more modern services. End users continuing to use PPCs will do so for a range of reasons: they need the specific characteristics of the PPC service; it is the only available option in the given geography; the customer is in contract; migration is not presently relevant. These remaining PPC customers require protection from unnecessary higher charges. The last thing that these customers want is to incur additional costs of service moves during the later months of their service being in situ.
- 9.27 Competitive entry into PPCs is not occurring. Competition in in the PPC market is if anything receding / concentrating – which can only be expected in a legacy market close to the end of its lifecycle. Many of the more peripheral network providers are exiting the market no longer wishing to offer or manage such legacy services. A number of CPs wishing to exit the PPC market have passed over the on-going management of their legacy PPC estate to Cable&Wireless Worldwide.
- 9.28 Over the coming years the number of installed PPC circuits will gradually fall. Investment in PPCs has effectively ceased. Focus remains on maintaining the required levels of services and assisting migration to more modern services.
- 9.29 Given the stage of the PPC product lifecycle we cannot agree with Ofcom’s proposals to find two trunk markets – one from regional and one for national trunk.
- 9.30 We disagree that there are prospects for greater competition in the national trunk market over the coming period. CPs are not actively investing today to build the capability to bypass BT’s TI trunk network. Indeed Cable&Wireless Worldwide has examined its own use of PPC national trunk. Even we, as the largest competitor to BT, continue to have a material annual spend with BT for national trunk with a considerable number of circuits continuing to use it.
- 9.31 Ofcom finds BT to have 45% to 49% market share in national trunk. Ofcom finds that BT has 87% market share in regional trunk. We disagree that two distinct markets exist or that national trunk has greater prospects for competition. As discussed in section 8 we consider a single trunk market continues to exist with BT have SMP across its entirety.
- 9.32 Cable&Wireless Worldwide disagrees with the proposals that BT put forward.

***Question 5: Do you agree with our approach to SMP assessment?***

- 9.33 Yes

**Question 6: Do you agree with our assessment of SMP for the retail low bandwidth TI market in the UK excluding the Hull area?**

9.34 Yes

**Question 7: Do you agree with our assessment of SMP for the wholesale TISBO markets in the UK excluding the Hull area?**

9.35 Yes

**Question 8: Do you agree with our assessment of SMP for the wholesale AISBO markets in the UK excluding the Hull area?**

9.36 Yes

**Question 9: Do you agree with our assessment of SMP for the wholesale MISBO markets in the UK excluding the Hull area?**

9.37 Yes noting our reservations about backhaul of MISBO in the WECLA area.

**Question 10: Do you agree with our assessment of SMP for the wholesale TI regional trunk market and the wholesale TI national trunk markets?**

9.38 No. Ofcom's own evidence shows that BT has a market share of 45 to 49% of that national trunk market that it proposes to find.

9.39 Cable&Wireless Worldwide disagrees that there are competitive differences between regional and national trunk that warrant the finding of separate markets given the advanced stage of the technology lifecycle of PPCs.

9.40 Cable&Wireless Worldwide considers that a single trunk market exists and that BT has SMP in that market.

**Question 11: Do you agree with our assessment of SMP for the retail low bandwidth TI market and the retail low bandwidth AI market in the Hull area?**

9.41 NA

**Question 12: Do you agree with our assessment of SMP for the wholesale TISBO and AISBO markets in the Hull area?**

9.42 NA

**Question 13: Do you agree with our approach to remedies and in particular our consideration of the case for imposing passive remedies?**

- 9.43 Cable&Wireless Worldwide disagrees with Ofcom's proposal not to adopt the cost orientation remedy. Discussion on this point can be found in section 4.
- 9.44 Cable&Wireless Worldwide disagrees with Ofcom's proposal to remove the regulatory accounting obligations. Discussion on this point can also be found in section 4
- 9.45 In the event that Ofcom does not maintain the cost orientation obligation then we propose that Ofcom revises Condition 1.2 to specifically include charges in the absence of a cost orientation obligation.
- 9.46 Cable&Wireless Worldwide proposes that BT is required to provide legacy WES to EAD LA migration on terms that are fair and reasonable compared to migration offers for other legacy WES to EAD services.
- 9.47 We also propose that EAD LA handover locations are aligned with NGA handover locations, for further discussion this issue please see section 6.
- 9.48 Cable&Wireless Worldwide supports Ofcom's proposals concerning ECCs, EOI for AI and MI services and space allocation.

**PASSIVE REMEDIES**

- 9.49 Ofcom specifically canvasses views on its conclusions with respect to not imposing PIA as a remedy. We have not placed the issue of passive remedies high on our priority list in this market review because our view has been that we would make limited use of it in the short term. However we are maintaining an open mind on that issue. Having said that we do see merit in making them available for business connectivity services and as such are not supportive of Ofcom's decision not to impose them.
- 9.50 We see several good reasons for them:
- a) First and foremost we cannot see how they can be useful in an NGA context if they are not available for use in meeting business connectivity requirements. The boundaries between these services are blurred. Crucially BT suffers no such restriction as part of its own investment case and it is impossible to think that an NGA investment case can be made on a stand-alone basis;
  - b) We have a slightly different perspective to Ofcom on the issue of their use for high bandwidth services. Ofcom says that because BT recovers more common cost on such services there is a risk of inefficient entry if operators try to use passive remedies. We agree with that risk, but the underlying issue must be addressed. Passive remedies are not the only way to market entry, the pressures of competition will encourage operators to find a way. Our preference here is to address the issue at its heart, Ofcom should tackle

the price of these high bandwidth circuits in particular where they are used for backhaul purposes. This is a big issue for our industry. However if Ofcom decides not to do that then it is better to have slightly inefficient entry with the use of passive remedies than very inefficient entry in other ways;

- c) Passive remedies can provide a valuable 'back stop' protection when BT refuses to take forward our requests through the SoR process. We do believe that in the majority of cases getting the right products available will be the most efficient way forward but in some cases, where those requirements are bespoke, passive remedies could provide a sensible alternative;

***Question 14: Do you agree with the remedies that we propose for BT in the low bandwidth TI retail market in the UK excluding the Hull area?***

9.51 yes

***Question 15: Do you agree with the remedies that we propose for BT in the wholesale TISBO markets in the UK excluding the Hull area and the wholesale TI regional trunk market?***

9.52 We address our concerns regarding the lack of cost orientation earlier.

***Question 16: Do you agree with the remedies that we propose for BT in the wholesale AISBO markets in the UK excluding the Hull area?***

9.53 We address our concerns regarding the lack of cost orientation earlier.

***Question 17: Do you agree with the remedies that we propose for BT in the wholesale MISBO markets?***

9.54 No. Cable&Wireless Worldwide considers it is necessary to have a direct price constraint on all MISBO services. The so called 'single interface' services will not form an adequate constraint on BT's prices. Primarily they are not a suitable alternative, our future backhaul requirements are for multiple 10Gbit/s not individual circuits and the most efficient way to provide them is using WDM. BT itself used WDM for its backhaul requirements and its competitors need to have access to the service at a comparable cost. In any event we understand BT will withdraw these services during the life of this review and we do not have clarity on their replacements.

9.55 Please see section 7 for further discussion on this issue.

***Question 18: Do you agree with the remedies that we propose for KCOM in the retail TI and AI markets? In particular, do you agree with our proposal that KCOM should be required only to publish maximum prices and to be permitted to offer bespoke discounts?***

9.56 Yes

***Question 19: Do you agree with the remedies that we propose for KCOM in the wholesale TISBO and AISBO markets? In particular, do you agree with our proposal that KCOM should be required only to publish maximum prices and to be permitted to offer bespoke discounts?***

9.57 Yes with respect to price publication.

## 10 LEASED LINE CHARGE CONTROL

### INTRODUCTION

- 10.1 The Leased Line Charge Control is a vital part of the regulation Ofcom imposes on BT in Business Connectivity markets and over the last 10 years there is a long history of issues with the price of the services now covered by the proposed control. It is absolutely correct for Ofcom to continue to impose charge controls in both the TI and AI markets and we are very supportive of the RPI-X type of control that Ofcom proposes retain following this review.
- 10.2 As BT's biggest external customer for TI services we consider that it is particularly important that we highlight the importance of TI services. Although clearly AI forms the majority of future demand TI services are, and will continue to be so for the period of this review and beyond, of significant importance for many customers. For some customers the unique performance characteristics of TI services mean that finding alternatives is particularly difficult, for others the change away from TI has massive knock on impacts on cost that mean it will be many years before such changes can be implemented. Customers know that eventually they must move away, particularly from sub 2Mbit/s services which will no longer be available after 2018, but even in the medium term many have no realistic alternative but to continue to purchase these services. It is vital that Ofcom continues to give these end users protection from prices increasing too far.
- 10.3 These end users have not enjoyed the best of experience in recent years. The sub 2 Mbit/s price increases implemented just prior to the start of the current control have been followed by further increases driven by unusually high RPI and BT's focus on implementing the most significant increases on low bandwidth circuits. These price increases have enabled BT to increase its return on mean capital employed from a very healthy 19% in 2007/8 to enviable 27% according to Ofcom's analysis of 2010/11 costs and revenues. Whilst we understand the last charge control was set based upon Ofcom's best view at the time and actual events will always turn out differently it is hard for those looking back to reconcile these fantastic returns for BT while they have faced into price increase after price increase in a market where they have no realistic alternative.
- 10.4 With that in mind Ofcom's proposal to allow TI services to rise by a further RPI+3.25% per year does not feel right. When one considers the RPI+10% sub-cap and typical inflation it is possible some services could increase by a further 40% over the duration of this control. That is 40% on top of significant increases over the last three years. It is 40% on a basket of services where BT has consistently enjoyed returns well above what could be expected in a competitive market. It is 40% on services that it is simply not possible for some users to find alternatives for within the next three years.
- 10.5 We do accept that BT's costs are bound to increase as volumes decline but, as Ofcom points out, much of the costs now allocated to these services are common cost shared with other markets and it is quite clear that the CVE and AVE approach does not deal with these properly

in the specific circumstances of these markets. Our view is that Ofcom has underestimated the common cost transfer out of TI, and further that it is not appropriate that all of this cost should be moved in to the AI basket. This, combined with an overly aggressive forecast for TI volume reductions, means that the proposals for TI allow greater price increases than can properly be justified.

- 10.6 Ofcom should revisit these assumptions, tightening both the value of X in the overall basket and the individual charge sub-caps in order to address these problems.
- 10.7 In the following sections we deal with some other specific issues and provide answers to Ofcom's questions where we make a number of other observations and suggestions. Our main additional points being:
- a) Now that the 2011/12 regulatory financial data is available we consider that Ofcom should update its modelling with the latest information. Whilst we believe it will make relatively little difference to the TI analysis the latest RFS do show that AI returns were both unusually low and dominated by legacy services in 2010/11;
  - b) We had to spend some time trying to understand the migration credit. Although we can now see the approach is justified in principle we consider it is wrong to use starting volumes as the basis for estimating the size of this adjustment as the LLCC model already includes both the costs and the revenues associated with the migrations that are forecast to occur during the three year period;
  - c) The use of prior financial year weights does not work well in markets such as these where the volumes are changing rapidly. We estimate that this has enabled BT to recover nearly £70m of additional revenue over the last three years. Ofcom should use either current year weights or weights from the prior six months;
- 10.8 These points aside we are largely supportive of Ofcom's analysis and its proposals. In particular we are pleased to see the inclusion of the RAV adjustment. It is clear that business connectivity services use the same duct infrastructure as the copper access products such as WLR and LLU and similar adjustments need to be made in these charge controls if the correct level of cost recovery is to be achieved.

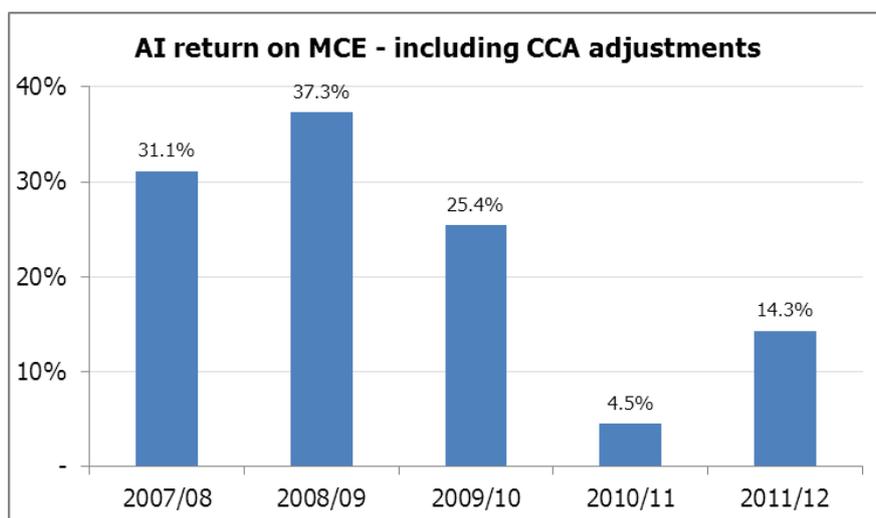
## 11 BASE YEAR DATA SHOULD BE BASED ON 2011/12 RFS

### 2010/11 IS NOT A REPRESENTATIVE YEAR IN TERMS OF PROFITABILITY

- 11.1 Ofcom proposes to use RFS data for 2010/11 as the base year for its LLCC model, as this was the most recent year for which fully audited regulatory statements were available in developing its proposals<sup>17</sup>.
- 11.2 Cable&Wireless Worldwide accepts that this was a reasonable approach in the context of Ofcom's consultation, which was published on 5<sup>th</sup> July 2012, before the 2011/12 RFS became available. However, the 2011/12 RFS were published shortly afterwards on 31<sup>st</sup> July 2012, and appear to indicate that 2010/11 is not a representative year for the forecast price control period. In particular:
- the profitability of AI services appears to have been temporarily depressed in 2010/11; and
  - the profitability of AI services in 2010/11 remains dominated by legacy Ethernet services, which are of limited relevance for the forecast price control period.

### AI profitability depressed

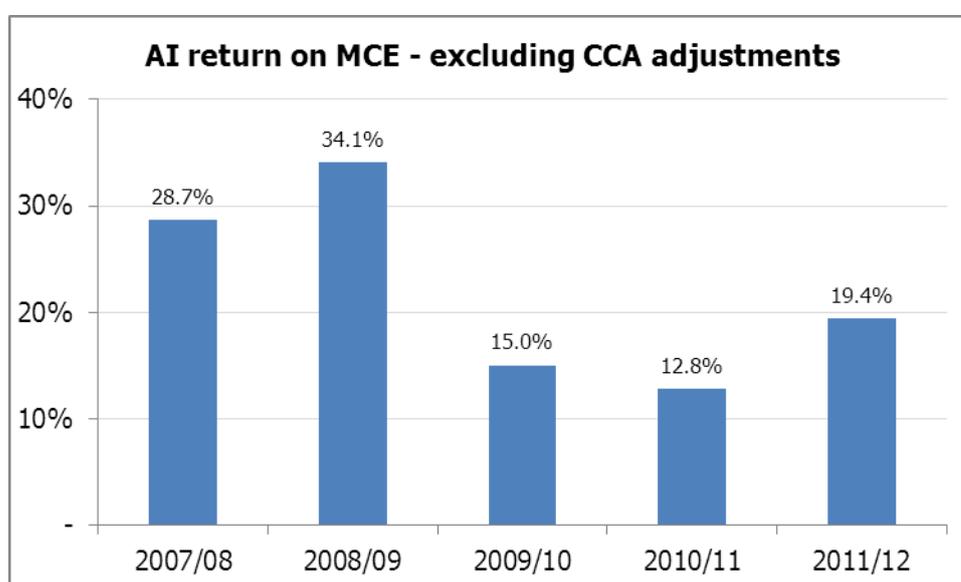
- 11.3 BT's RFS suggest a return on MCE of 4.5% for AI services in 2010/11<sup>18</sup>. This is well below preceding years, and some 10% below the reported return in 2011/12.



<sup>17</sup> 4.34

<sup>18</sup> This includes services outside the scope of the AI basket, such as services delivered within the WECLA. However, we do not have the data necessary to strip out the effect of out of scope services, so we adopt the profitability of all reported AI services as a proxy for the profitability of AI services within the scope of the AI basket.

11.4 We are aware that one of the reasons for returns fluctuating from one year to the next is the volatile impact of holding gains/losses and other CCA adjustments, which Ofcom addresses by applying a “current cost normalisation” adjustment. Therefore, the relevant question is whether AI profitability remains unrepresentative in 2010/11 following application of this adjustment. We do not have the information necessary to estimate this directly, but as a proxy we have considered the trend in AI profitability with CCA adjustments to operating costs removed<sup>19</sup>. Considered on this basis, 2010/11 profitability remains depressed relative to other years. In particular, the 2011/12 return on MCE is over 50% higher than the 2010/11 return.



11.5 The latest available evidence therefore suggests that the profitability of AI services appears to have been temporarily depressed in 2010/11, and that 2010/11 was not a representative year for the forecast price control period<sup>20</sup>.

**Dominated by legacy Ethernet services**

11.6 A further significant limitation with 2010/11 RFS data is that the profitability of AI services in 2010/11 remains dominated by legacy Ethernet services, with new Ethernet services comprising only a small proportion of revenues. That proportion nearly doubles in 2011/12:

<sup>19</sup> We have removed reported holding gains/losses, supplementary depreciation, and other CC adjustments from reported CCA operating costs.

<sup>20</sup> We have performed a similar analysis for TI services. This suggests relatively little difference between 2010/11 and 2011/12 profitability, with the latter marginally higher.

Revenues (£m) <sup>21</sup>	2010/11	2011/12
Legacy: WES, BES <sup>22</sup>	297	277
New: EAD, EBD, BTL	93	233
Other <sup>23</sup>	164	215
	554	725
New / (Legacy + New)	24%	46%

11.7 The profitability of legacy Ethernet services is however of very limited relevance for the charge control:

- a) by 2015/16, the AI basket is forecast to comprise mainly new Ethernet services, with low volumes of legacy Ethernet services remaining; and
- b) Ofcom's proposal to use an MEA approach for legacy Ethernet services means that their forecast profitability will be based on the profitability of new Ethernet services, not that of legacy Ethernet services.

11.8 It is the profitability of new Ethernet services that is therefore of most relevance. However, basing that profitability on 2010/11 data forces Ofcom to extrapolate from a base that is not only less recent, but also considerably smaller. This makes extrapolation/forecasting much less reliable.

**FORECASTS BASED SOLELY ON 2010/11 WOULD BE UNRELIABLE, OFCOM SHOULD REFLECT 2011/12 DATA IN ITS STATEMENT**

11.9 For the reasons set out above, now that 2011/12 RFS data is available, it is clear that 2010/11 is not a representative year for the forecast price control period. Using 2010/11 alone as the base year is likely to result in forecasts which much less reliable, than those which could be generated based on 2011/12. Cable&Wireless Worldwide submits that Ofcom should adopt the 2011/12 RFS as the base year for its statement, or at the very least amend its 2010/11 based forecasts in the light of the information in the 2011/12 RFS.

11.10 This would be consistent with the approach taken in the 2009 control review. In that review, Ofcom published its consultation in December 2008 and its statement seven months later in July 2009. The consultation was based solely on the 2006/07 RFS<sup>24</sup>, whereas the statement also reflected the 2007/08 RFS<sup>25</sup>.

<sup>21</sup> Source: BT RFS

<sup>22</sup> Including "Other Ethernet rentals" and "Other Ethernet connections", reported directly after BES and before EAD

<sup>23</sup> Including "Main link rental charges", "Equipment depreciation", "Excess construction charges", and "Roundings".

<sup>24</sup> 3.88, December 2008 Consultation

<sup>25</sup> See for example 4.80, July 2009 Statement

11.11 In the current review, Ofcom anticipates publishing its statement early in 2013<sup>26</sup>, i.e. in the first quarter of 2013<sup>27</sup>. This allows a six to eight month gap between the consultation and the statement - essentially the same gap which allowed Ofcom to update its analysis for the latest RFS data in the last review.

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<sup>26</sup> 1.17

<sup>27</sup> 10.56

## 12 TI COMMON COST ALLOCATION

### BT'S FORECASTING APPROACH MISALLOCATES COMMON COSTS

12.1 As identified in the 2009 charge control and reiterated in the current consultation, BT's approach to forecasting costs based on AVEs/CVEs does not reflect the need to revise common cost allocations to individual services as the volume of those services changes, relative to the volume of other services sharing the same common costs<sup>28</sup>.

12.2 For example, in relation to capital costs, Ofcom states:

*"Cost components are defined in BT's system such that TI and Ethernet services do not share the same underlying cost components, even though these components use the same underlying assets. So, if TI volumes fall by 75%, the unit cost of the duct allocated to TI at the start of the period would increase significantly, to reflect the fact that fixed costs would then only be allocated over a quarter of the original volumes. Conversely, if Ethernet volumes rise by 50% the unit cost allocated to Ethernet would fall significantly. We consider that this is not an accurate prediction of the true cost evolution as we would expect BT to allocate costs to reflect the changing use of the assets."*<sup>29</sup>

12.3 Similarly, in relation to admin-related capital and operating costs, Ofcom states:

*"The implied AVEs and CVEs are between 0.2 and 0.5. With the dramatic changes in volumes, this implies significant changes in the unit costs at the service level, and, as volumes increase substantially; total admin costs are also forecast to increase very significantly, at a rate which implies a cost volume relationship well above the weighted average CVE in the base year. Since these costs are allocated on a top-down basis, we believe that as volumes increase they would attract a higher allocation of these costs, and the same would apply when volumes decline. The AVEs and CVEs by service in the base year are in effect a snapshot based on current allocation methodologies."*<sup>30</sup>

12.4 The resulting misallocation of common costs is a serious and fundamental failing in circumstances where:

- a) common costs are significant; and
- b) relative volumes of different services are forecast to change significantly.

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<sup>28</sup> The problem arises both in respect of services, and in respect of groups of services.

<sup>29</sup> A5.247

<sup>30</sup> A5.241

12.5 Both of these circumstances clearly apply in the case of the TI and AI charge controls. As a result, it is unsafe to assume that any unadjusted forecast based on BT's AVE/CVE approach gives a reliable indication of the future level of costs.

#### **OFCOM'S PROPOSALS DO NOT FULLY ADDRESS THE MISALLOCATION PROBLEM**

12.6 In the 2009 charge control, Ofcom established an approach to reallocating costs between the TI and AI baskets to correct for this misallocation of common costs. Ofcom stated that without the reallocation, services with declining volumes would, due to the misallocation of common costs, see material increases in unit costs, and that the purpose of the reallocation was to avoid:

*"the rapid increases in TI unit costs which would result from a constant amount of fixed costs being recovered from an ever-smaller volume of TI services"*<sup>31</sup>.

12.7 Ofcom's proposals for the current control however, fail to prevent the increases in unit costs which Ofcom sought to avoid in the 2009 control. Unit costs are forecast to rise by nearly 50% over a five year period:

TI capital + operating costs	2010/11	2015/16
Total costs (£m) <sup>32</sup>	534	205
Circuits (000) <sup>33</sup>	449	119
Unit cost (£)	1,191	1,720
Rise in unit cost		44%

12.8 Nowhere in the consultation does Ofcom explain how such a significant increase in unit costs is consistent with the cost drivers underlying TI services. In particular, there is no evidence of significant TI-specific fixed costs which would explain such an increase<sup>34</sup>. In the context of the known failings in BT's forecasting approach, the clear implication is that the increase is due to Ofcom's proposed approach inadequately addressing these failings and incompletely removing the common cost over-allocation from the TI basket. As Ofcom itself confirms in respect of capital costs:

*"For TI services, capital costs can be divided into costs for TI-specific assets and costs for common assets which are used to provide other services in addition to TI services. By the end of the charge control period, virtually all of the TI-specific assets will be almost or fully*

<sup>31</sup> 4.259 to 4.261, July 2009 Statement

<sup>32</sup> Row 3, BasketX.BTW, BTW services basket, Ofcom LLCC data file

<sup>33</sup> Row 229, FC.RentalsByBasket, Volume Forecasts, Ofcom LLCC data file

<sup>34</sup> In theory, an increase in unit costs could be driven by a change in the mix of products within the basket towards more costly circuits. However, there is no evidence of a consistent trend from one year to the next in this direction of the scale required for the forecast increase in unit costs. This implies that the forecast unit cost of each specific TI service is, on average, forecast to rise sharply over the period.

*depreciated. The rise in unit capital costs is thus mainly attributable to common cost allocation.”*<sup>35</sup>

## **OFCOM'S PROPOSED APPROACH TO ADMIN-RELATED COSTS**

### **BT's forecasting system misallocates admin-related costs**

12.9 Ofcom makes it clear that BT's AVE/CVE based approach to forecasting costs misallocates admin-related costs, which by their nature are overwhelmingly not incremental to specific services but are instead common and allocated to services on a top-down basis:

*“The implied AVEs and CVEs are between 0.2 and 0.5. With the dramatic changes in volumes, this implies significant changes in the unit costs at the service level, and, as volumes increase substantially; total admin costs are also forecast to increase very significantly, at a rate which implies a cost volume relationship well above the weighted average CVE in the base year. Since these costs are allocated on a top-down basis, we believe that as volumes increase they would attract a higher allocation of these costs, and the same would apply when volumes decline. The AVEs and CVEs by service in the base year are in effect a snapshot based on current allocation methodologies.”*<sup>36</sup>

### **Ofcom's proposed modified approach is inappropriate**

12.10 Ofcom proposes a modified approach to cost forecasting to correct for the misallocation of common costs under BT's approach. However, instead of reflecting its own conclusions on the limitations of an AVE/CVE based forecasting approach, and adopting an approach which does not rely on these flawed forecasting tools, Ofcom proposes an approach which applies AVEs/CVEs at the basket level, rather than the service level<sup>37</sup>.

12.11 It is not clear how a move to the basket level can be expected to address the limitations identified by Ofcom in the AVE/CVE approach. If changing relative volumes at the service level leads that approach to a misallocation of common costs between services, as stated by Ofcom, it must also be true that the expected change in relative volumes at the basket level will lead the AVE/CVE approach to a misallocation of common costs between baskets. Ofcom's proposed reliance on AVEs/CVEs for forecasting what are essentially common costs is inconsistent with its own conclusions on the reliability of those measures in respect of such costs.

12.12 Ofcom's proposed reliance on AVEs/CVEs for forecasting admin-related costs also appears inconsistent with its proposals for other capital and operating costs (i.e. cable, duct, land and buildings capital costs, and non-admin related operating costs). In those latter cases, Ofcom explicitly recognises the limitations of an AVE/CVE based approach, and instead of simply moving from the service to the basket level, it proposes approaches which focus on reallocating

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<sup>35</sup> A5.250

<sup>36</sup> A5.241

<sup>37</sup> A5.242

non-marginal costs and moderating the increase in unit costs<sup>38</sup>. Ofcom does not explain why it chooses to apply an entirely different remedy in the case of admin-related costs, which are subject to the same AVE/CVE common cost allocation problem.

### Ofcom's proposed approach results in rapid unit cost increases

12.13 The deficiencies in Ofcom's proposed approach to admin-related costs become quickly apparent when its impact on unit costs is considered. The approach results in a more than doubling of unit admin-related costs:

TI admin-related costs (capital + operating costs)	2010/11	2015/16, including efficiencies	2015/16, excluding efficiencies
Total costs (£m) <sup>39</sup>	71	44	47
Circuits (000) <sup>40</sup>	449	119	119
Unit cost (£)	158	370	395
Rise in unit cost		134%	152%

12.14 In the 2009 charge control, Ofcom explicitly sought to avoid "the rapid increases in TI unit costs which would result from a constant amount of fixed costs being recovered from an ever-smaller volume of TI services"<sup>41</sup>. Yet Ofcom's proposed approach to admin-related costs clearly exhibits precisely these features.

12.15 As pointed out by Ofcom, these admin-related costs are allocated top down. Such costs will be common across many services, and in the absence of any specific evidence of significant TI-specific fixed costs<sup>42</sup>, or significant rises in admin-related costs across all services, there is no reason to believe that allocated unit costs should rise in this way.

12.16 The approach to admin-related costs should be brought into line with the approach to other capital and operating costs (i.e. cable, duct, land and buildings capital costs, and non-admin related operating costs). Admin-related TI costs should be forecast on a basis consistent with

<sup>38</sup> A5.255 to A5.267

<sup>39</sup> 2010/11 and 2015/16 "including efficiencies" figures estimated from Figure A5.13. 2015/16 "excluding efficiencies" figure reverses 5 years' worth of 1.5% efficiency improvements (based on the conclusion at A5.81) to show the underlying increase in unit costs, absent efficiency improvements.

<sup>40</sup> Row 229, FC.RentalsByBasket, Volume Forecasts, Ofcom LLCC data file

<sup>41</sup> 4.259 to 4.261, July 2009 Statement

<sup>42</sup> We note that Table A5.26 identifies £68m of admin-related costs in 2010/11 in respect of "SG&A partial private circuits", "SG&A private circuits" and "PPC support services". However, there is no apparent evidence to suggest that these activities have a significant fixed or non-marginal component.

those costs: namely, assuming constant 2010/11 unit costs, adjusted where appropriate for operating cost efficiencies<sup>43</sup>.

12.17 Cable&Wireless Worldwide estimates that this would lead to a unit cost of £147 per circuit in 2015/16<sup>44</sup>, and total TI admin-related costs of £17m: £27m less than currently assumed.

12.18 This £27m should either be removed from the TI+AI cost base altogether, to the degree that these costs would either be properly allocated to services other than TI and AI (or avoided altogether), or reallocated to the AI cost base, to the degree that the allocation of these costs would properly switch from TI services to AI services over time.

## OFCOM'S PROPOSED APPROACH TO OTHER OPERATIONAL CAPITAL COSTS

### Implied unit cost increases are dramatic

12.19 Ofcom's proposed approach to admin-related costs appears to be the main cause of increasing TI unit operating costs. However, even if the effect of increased unit admin-related costs is stripped out, TI unit capital costs are still forecast to rise sharply:

TI capital costs, excluding admin-related capital costs	2010/11	2015/16
Total costs (£m) <sup>45</sup>	198	89
Circuits (000) <sup>46</sup>	449	119
Unit cost (£)	442	749
Rise in unit cost		70%

12.20 The unit costs figures quoted above are stated after taking account of Ofcom's proposed reallocation in respect of cable, duct, land and buildings capital costs. This has the effect of keeping unit costs fixed for this cost category, meaning that the implied unit cost increases for other operational asset capital costs are dramatic:

<sup>43</sup> This approach assumes that TI-specific fixed or non-marginal admin-related costs are negligible. If there is evidence, other than from AVE/CVE values (which have been established as unreliable for these purposes), of significant TI-specific non-marginal costs, then some increase in unit costs may be warranted.

<sup>44</sup> The £158 figure for 2010/11, adjusted for 5 years' worth of 1.5% efficiency improvements (based on the conclusion at A5.81)

<sup>45</sup> 2015/16 figure is sourced from Table A5.29. 2010/11 figure is estimated based on the 2015/16 figure, inflated by the ratio of circuit volumes in 2010/11 to circuit volumes in 2015/16, in line with Ofcom's stated approach for deriving the 2015/16 figure in Table A5.29. Figures would be slightly but not significantly different if the detailed calculations were based on component volumes rather than circuit volumes (A5.257 identifies a 70% fall in TI component volumes, compared with a 73% fall in TI circuit volumes).

<sup>46</sup> Row 229, FC.RentalsByBasket, Volume Forecasts, Ofcom LLCC data file

TI capital costs, excluding admin-related capital costs	2010/11	2015/16
Cable, duct, land and buildings (£m) <sup>47</sup>	109	29
Circuits (000) <sup>48</sup>	449	119
Unit cost (£)	244	244
Rise in unit cost		-
Other operational assets (£m) <sup>49</sup>	89	60
Circuits (000)	449	119
Unit cost (£)	198	505
Rise in unit cost		155%
Total (£m) <sup>50</sup>	198	89
Circuits (000)	449	119
Unit cost (£)	442	749
Rise in unit cost		70%

12.21 Unit costs for other operational assets are therefore forecast to rise from less than £200 to over £500. Nowhere in the consultation does Ofcom explain how such a significant increase in unit costs is consistent with the cost drivers underlying TI services. In particular, there is no evidence of significant TI-specific fixed costs which would explain such an increase. In the context of the known failings in BT's forecasting approach, the clear implication is that the increase is due to Ofcom's proposed approach inadequately addressing these failings and not removing the common cost over-allocation from the TI basket. As Ofcom itself confirms in respect of capital costs:

*"For TI services, capital costs can be divided into costs for TI-specific assets and costs for common assets which are used to provide other services in addition to TI services. By the end of the charge control period, virtually all of the TI-specific assets will be almost or fully depreciated. The rise in unit capital costs is thus mainly attributable to common cost allocation."*

<sup>51</sup>

<sup>47</sup> 2015/16 figure is sourced from Table A5.29 (£149m before reallocation, less £14m admin-related, less £46m reallocated under Ofcom proposals). 2010/11 figure is based on the figure of £221m from Ofcom's LLCC data file (Row 53, BasketX.BTW, BTW basket), less an estimated admin-related capital cost of £23m (being £14m, inflated back to 2010/11 levels according to the £71m/£44m ration estimated from Figure A5.13).

<sup>48</sup> Row 229, FC.RentalsByBasket, Volume Forecasts, Ofcom LLCC data file

<sup>49</sup> Calculated as the difference between cable, duct, land and buildings costs and total costs.

<sup>50</sup> 2015/16 figure is sourced from Table A5.29 (£149m before reallocation, less £14m admin-related, less £46m reallocated under Ofcom proposals). 2010/11 figure is based on the figure of £221m from Ofcom's LLCC data file (Row 53, BasketX.BTW, BTW basket), less an estimated admin-related capital cost of £23m (being £14m, inflated back to 2010/11 levels according to the £71m/£44m ration estimated from Figure A5.13).

<sup>51</sup> A5.250

**Unit cost increases are caused by Ofcom’s changed approach**

12.22 The anomalous increase in unit costs identified above appears to be attributable to Ofcom’s changed approach to forecasting unit costs.

12.23 In the 2009 charge control, Ofcom established an approach to reallocating capital costs between the TI and AI baskets to correct for the misallocation of common costs resulting from BT’s AVE/CVE based approach. Ofcom stated that without the reallocation, services with declining volumes would, due to the misallocation of common costs, see material increases in unit costs, and that the purpose of the reallocation was to avoid:

*“the rapid increases in TI unit costs which would result from a constant amount of fixed costs being recovered from an ever-smaller volume of TI services.”<sup>52</sup>*

12.24 The approach essentially reallocated costs wrongly identified by BT’s forecasting approach as non-marginal or fixed to TI services, on the assumption that in practice their allocation would change to AI services over time, and that as a result associated TI unit costs would stay constant in real terms, other things being equal<sup>53</sup>.

12.25 For reasons which have not been explained in the consultation, Ofcom now proposes to modify the approach established in the 2009 charge control. While the established approach is essentially retained in respect of all operating costs, and cable, duct, land and buildings capital costs, Ofcom proposes the adoption of a new approach in respect of other operational assets:

Proposed reallocation approach	Capital costs	Operating costs
Cable, duct, land and buildings	Established	Established
Other operational	New	

12.26 The new approach for other operational assets would appear to consist of making no adjustments whatsoever in respect of BT’s AVE/CVE based forecasts.

12.27 Ofcom has not explained why such a change is appropriate. It cannot be assumed that common costs are insignificant for other operational assets; the consultation makes it clear that, while common costs may be particularly significant for cable, duct, land and building costs and admin-related costs, common costs are also present for other operational assets (emphasis added):

*“Many of the costs required to deliver TI and Ethernet services are common. For example,*

<sup>52</sup> 4.259 to 4.261, July 2009 Statement

<sup>53</sup> See for example A7.179 to A7.183 of the July 2009 Statement

*assets (such as duct, land and buildings) as well as operational and administration costs are used to support leased lines across the two markets.”*<sup>54</sup>

- 12.28 These common costs are likely to be significant: the consultation states that by 2015/16, virtually all TI-specific assets will be almost fully or fully depreciated<sup>55</sup>. Therefore, a significant proportion of these costs appear to relate to asset types which are used to provide other services in addition to TI services.
- 12.29 Even if common costs are, per £m of capital cost, less significant for other operational assets than they are for cable, duct, land and building costs, the fact that other operational assets comprise over two thirds of the 2015/16 capital cost base<sup>56</sup> means that common costs for this category remain significant, in overall terms.
- 12.30 Ofcom is under no obligation to retain an established approach established for the 2009 control where a better approach is available. However, its proposed new approach is clearly less effective than the established approach at addressing a confirmed and undisputed failing in BT’s forecasting approach:
- a) it appears to assume, without any supporting evidence, that other operational asset costs do not feature a large common cost component, and/or that this cost category is unaffected by the failings of BT’s approach to forecasting common cost allocations; and
  - b) it fails to avoid the rapid increase in unit costs which Ofcom clearly guarded against in setting the 2009 control.
- 12.31 Cable&Wireless Worldwide submits that the proposed approach must be amended so that it is at least as effective as the established approach. One way of achieving this would be to extend the approach currently proposed for cable, duct, land and buildings to other operational assets<sup>57</sup>. We estimate that this would lead to a TI unit capital cost of £442 per circuit in 2015/16, and total TI capital costs of £53m (excluding admin-related costs): £36m less than currently assumed.
- 12.32 This £36m should either be removed from the TI+AI cost base altogether, to the degree that these costs would either be properly allocated to services other than TI and AI (or avoided altogether), or reallocated to the AI cost base, to the degree that the allocation of these costs would properly switch from TI services to AI services over time.

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<sup>54</sup> A5.246

<sup>55</sup> A5.250

<sup>56</sup> Post Ofcom reallocation in respect of cable, duct, land and building capital costs

<sup>57</sup> This approach assumes that TI-specific fixed or non-marginal costs are negligible. If there is evidence, other than from AVE/CVE values (which have been established as unreliable for these purposes), of significant TI-specific non-marginal costs, then some increase in unit costs may be warranted.

**IMPACT OF OTHER SERVICES ON COMMON COST ALLOCATION**

12.33 As noted above in the case of both admin-related costs and other operational asset capital costs, the excess common costs currently allocated to TI should either be:

- a) removed from the TI+AI cost base altogether, to the degree that these costs would either be properly allocated to services other than TI and AI (or avoided altogether); or
- b) reallocated to the AI cost base, to the degree that the allocation of these costs would properly switch from TI services to AI services over time.

12.34 A consideration of product substitution suggests that the former approach should play a substantial role. We consider that this is also true for the duct and fibre costs Ofcom has already proposed to re-allocate. It is evident that many low bandwidth circuits have migrated from TI to WBA or WLA LLU services. This type of migration is however now largely historic in that it has already been undertaken. End users who considered the product specification of LLU and broadband to sufficiently meet their needs rapidly switched from TI circuits as is evidenced by the drop in volumes for low bandwidth TI services over the last control period.

12.35 Looking forward we can assume that the end users remaining either require services of higher bandwidth or higher specification than copper LLU and broadband services. It is expected that customers migrating will not all move to AI services and many will in fact take up NGA services, depending upon availability and specific requirement.

12.36 It is therefore a relevant consideration that the common costs moving out of the TI basket are allocated to both NGA and AI services. Given that NGA is not a service within a charge control the movement of these common costs will not deny BT the opportunity for full cost recovery.

## 13 MIGRATION CREDIT IS OVERSTATED

### THE MEA APPROACH ALREADY COVERS A PROPORTION OF TRANSITION COSTS

13.1 Ofcom states that, in the absence of a migration credit, its proposed MEA approach:

*“does not take into account the transition costs in migrating from legacy to new Ethernet services.”<sup>58</sup>*

13.2 The statement could be interpreted in two ways:

- a) that its MEA approach does not take into account all transition costs; or
- b) that its MEA approach does not take into account any transition costs.

13.3 We agree with the first interpretation, but not the second. Ofcom’s MEA approach already recovers a proportion of transition costs, because:

- a) the forecast cost base in every year of the price control, including the final year of the price control, reflects the aggregate cost of all forecast service volumes in that year;
- b) service volumes in every year include connection services for customers who are forecast to transition from legacy to new Ethernet services during the period of the price control; and
- c) the allowable cost base in the price control period already allows for the recovery of transition costs in respect of those customers who are forecast to transition.

#### **The forecast cost base reflects the aggregate cost of service volumes**

13.4 The model forecasts service volumes in every year of the price control. In the AI basket (and the TI basket), these include both rental services and connection services<sup>59</sup>.

13.5 The forecast cost base is derived by adjusting a ‘steady state’ cost estimate, based on existing service volumes, with an ‘additional’ element, reflecting the impact of forecast changes in the volume of each service<sup>60</sup>.

13.6 Thus the forecast cost base in every year of the price control, including the final year of the price control, reflects the aggregate cost of all forecast service volumes in that year.

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<sup>58</sup> A5.232

<sup>59</sup> Rows 457 to 470, FC.ServVolumes, Volume Forecasts, Ofcom LLCC data file; rows 457 to 470, FC.ServMEA, Volume Forecasts, Ofcom LLCC data file

<sup>60</sup> A5.183ff

### Service volumes include connection services for customers forecast to transition

13.7 Forecast service volumes include a total of over 90,000 connections to new Ethernet services over the period of the price control:

Forecast volumes <sup>61</sup>	2013/14	2014/15	2015/16	Total
EAD up to 1Gbit/s connection	31,236	29,293	29,492	90,021

13.8 Over the same period, the volume of legacy Ethernet rentals is forecast to fall by over 60,000:

Forecast volumes <sup>62</sup>	2012/13	2015/16	Reduction
WES 10Mbit/s rental	40,826	11,383	29,443
WES 100Mbit/s rental	36,758	15,099	21,659
WES 1000Mbit/s rental	5,683	2,230	3,453
WES other rental	10,228	2,633	7,595
Total	93,495	31,345	62,150

13.9 As noted by Ofcom and implicit in its calculation of the migration credit, the driving force for the fall in legacy Ethernet rentals is transition from legacy Ethernet services to new Ethernet services<sup>63</sup>. Of the legacy Ethernet rentals in place at the start of the price control period, two-thirds<sup>64</sup> are forecast to transition during the period of the price control<sup>65</sup>.

13.10 It is therefore clear that a significant proportion of forecast EAD connection services are a direct result of the forecast transition from legacy to new Ethernet services during the price control period.

13.11 This is not affected by Ofcom's application of the MEA approach. Ofcom's model clearly indicates that while the application of this approach affects the volume of WES v EAD rentals assumed for the forecasting of the cost of rental service volumes, it does not affect the volume of EAD connections assumed for the forecasting of the cost of connection volumes. Forecast EAD connections are equal to 90,021, both before and after the application of the MEA approach<sup>66</sup>.

<sup>61</sup> Row 458, FC.ServVolumes, Volume Forecasts, Ofcom LLCC data file

<sup>62</sup> Rows 466, 464, 462 and 468, FC.ServVolumes, Volume Forecasts, Ofcom LLCC data file

<sup>63</sup> See for example 6.69, 6.102, A5.49 to A5.50, and A5.236

<sup>64</sup> 62,150 / 93,495

<sup>65</sup> We base our analysis on WES rentals, as the information supplied discloses forecast volumes for these services. We recognise that Ofcom has based its migration credit on WEES and BES rentals as well (A5.236). However, we expect similar considerations to apply to those services.

<sup>66</sup> Row 458, FC.ServVolumes, Volume Forecasts, Ofcom LLCC data file; row 458, FC.ServMEA, Volume Forecasts, Ofcom LLCC data file

13.12 Therefore, under Ofcom’s MEA approach, service volumes in every year include EAD connection services for customers who are forecast to transition from legacy to new Ethernet services during the period of the price control.

**The allowable cost base already allows for the recovery of transition costs for forecast transitions**

13.13 As shown above:

- a) the forecast cost base in every year of the price control, including the final year of the price control, reflects the aggregate cost of all forecast service volumes in that year; and
- b) under Ofcom’s MEA approach, service volumes in every year include EAD connection services for customers who are forecast to transition from legacy to new Ethernet services during the period of the price control.

13.14 Under Ofcom’s MEA approach, and before the application of any migration credit, the allowable cost base in the price control period thus already allows for the recovery of transition costs in respect of those customers who are forecast to transition during the period of the price control. At the levels forecast, this allowance is equal to two-thirds of the cost of transitioning all legacy Ethernet rentals in place at the start of the price control period.

**THE MIGRATION CREDIT ONLY NEEDS TO FUND UNCOVERED TRANSITION COSTS**

13.15 Given Ofcom’s proposal to adopt the MEA approach, the purpose of the migration credit is to ensure that BT has the opportunity to recover the cost of transitioning all legacy Ethernet rentals in place at the start of the price control period (“total potential transition costs”)<sup>67</sup>.

13.16 As set out above, in the absence of a migration credit, the allowable cost base already gives BT the opportunity to recover two-thirds of total potential transition costs. Therefore, the migration credit only needs to fund the remaining one-third of total potential transition costs.

**The proposed migration credit double counts transition costs already covered and leads to an over-recovery of costs**

13.17 Ofcom explains in the consultation that the migration credit of £43m is based on the cost of migrating all legacy Ethernet rentals in place at the start of the charge control (emphasis added):

*“We have carried out the following steps to calculate the migration credit.*

- *Each of the WES, WEES and BES services that will need to be migrated to new Ethernet services were assigned a corresponding MEA service (i.e. an EAD/EBD service of the same / similar bandwidth).*

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<sup>67</sup> 6.95 to 6.97

• *The forecasted rental volumes of the relevant WES, WEES and BES services at the beginning of the charge control were multiplied by the forecasted unit connection costs of the corresponding MEA services at the beginning of the charge control.*

*Using this methodology, we have calculated that the migration credit we propose to allow will be approximately £43m.”<sup>68</sup>*

13.18 Since the allowable cost base already gives BT the opportunity to recover two-thirds of total potential transition costs, adding a migration credit to this cost base which gives BT the opportunity to recover the entirety of total potential transition costs means that two-thirds of total potential transition costs are allowed twice over. Such a migration credit would double count two-thirds of transition costs, and allow an over-recovery of costs. An over-recovery of costs is both unwarranted and inconsistent with Ofcom’s stated aims.

**The migration credit should be reduced to reflect transition costs already covered**

13.19 To avoid double counting and over-recovery, the migration credit should be reduced by two-thirds, to one-third of total potential transition costs. This would cause the credit to fall from a total of £43m (and an allowance of £14.3m in 2015/16<sup>69</sup>) to a total of £14.3m (and an allowance of £4.8m in 2015/16).

**Transition costs should not contribute to subsequent glide path**

13.20 Ofcom explains that its general preference is to apply a ‘glide path’ approach, which allows a gradual convergence of prices and costs over the period of the control. Ofcom states that one of the main benefits of such an approach is that it allows regulated firms to retain the benefits of cost reductions made under a previous price control for longer<sup>70</sup>.

13.21 Cable&Wireless Worldwide accepts there is some merit in this argument, to the degree that prices are designed to recover types of costs which span across control periods. However, Ofcom makes it clear that under its MEA approach, the allowance for transition costs is not designed to span control periods in this way:

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<sup>68</sup> A5.236 to A5.237

<sup>69</sup> Assuming, as Ofcom does, that the credit is taken into account by assuming even migration over the three years of the price control period (A5.237).

<sup>70</sup> 4.97 to 4.100

*“We believe that our proposed migration credit will compensate Openreach appropriately for migrating customers. Therefore, it is limited to our proposed charge control and is not a policy that we propose to extend indefinitely. This is regardless of how many customers Openreach migrates to the new Ethernet services, since our policy proposals should not be determined by Openreach’s actions. Rather, they should provide the conditions under which Openreach is incentivised to become more efficient. We believe that this will prevent Openreach from having an incentive to delay migrations, with the aim of attempting to justify further migration credits in future.”<sup>71</sup>*

13.22 Therefore, Cable&Wireless Worldwide submits that the total allowance for transition costs, from both the allowable cost base and the migration credit (i.e. total potential transition costs), should be deducted from starting prices at the beginning of the next price control at the end of 2015/16, and should not contribute to the glide path in that price control period. Inclusion in the glide path would have the effect of funding transition costs beyond 2015/16, in direct contradiction to Ofcom’s stated aim.

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<sup>71</sup> 6.106

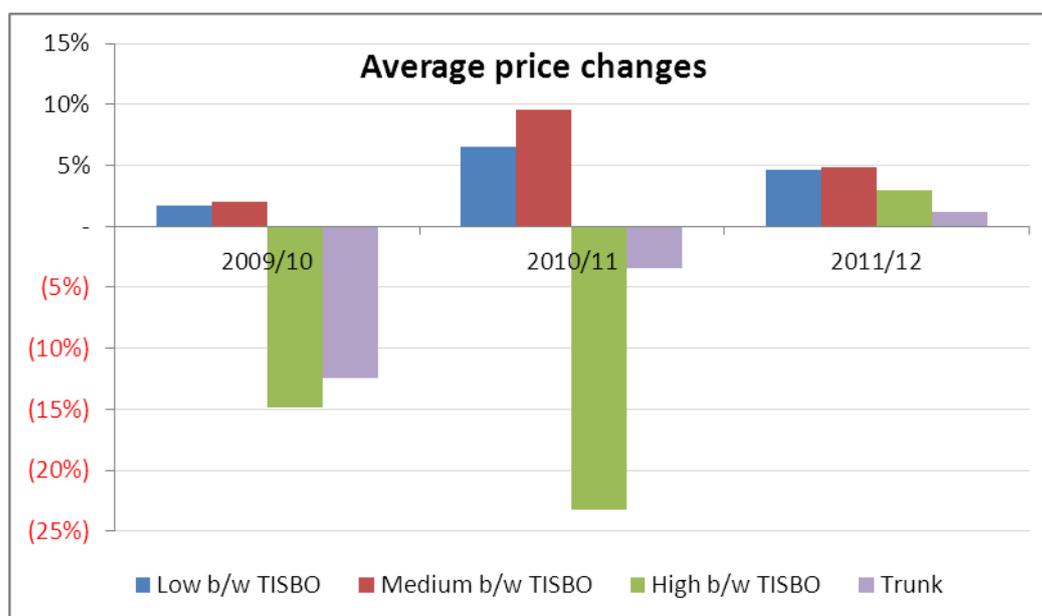
## 14 PRIOR YEAR BASKET WEIGHTS

### PRICE CHANGES UNDER 2009 CONTROL HAVE NOT BEEN UNIFORM

14.1 The price changes effected by BT under the 2009 control have not been uniform. In broad terms:

- a) price rises have been focussed on low and medium bandwidth TISBO services; and
- b) price falls have been focussed on high bandwidth TISBO and trunk services<sup>72</sup>.

14.2 The graph below summarises our estimates of average price changes, by charge control year, based on BT's published pre-discount charges<sup>73</sup>:



14.3 A consistent pattern is evident. In 2009/10 and 2010/11, low and medium bandwidth TISBO services are subject to price rises, while high bandwidth TISBO and trunk services enjoy significant price falls. In 2011/12, all services are subject to price rises, but those for low and medium bandwidth TISBO services are higher than those for high bandwidth TISBO and trunk services.

<sup>72</sup> Low, medium and high bandwidths are defined in line with the current control, i.e. up to and including 8Mbps for low, above 8Mbps up to and including 34/45Mbps for medium, and above 34/45Mbps up to and including 140/155Mbps for high.

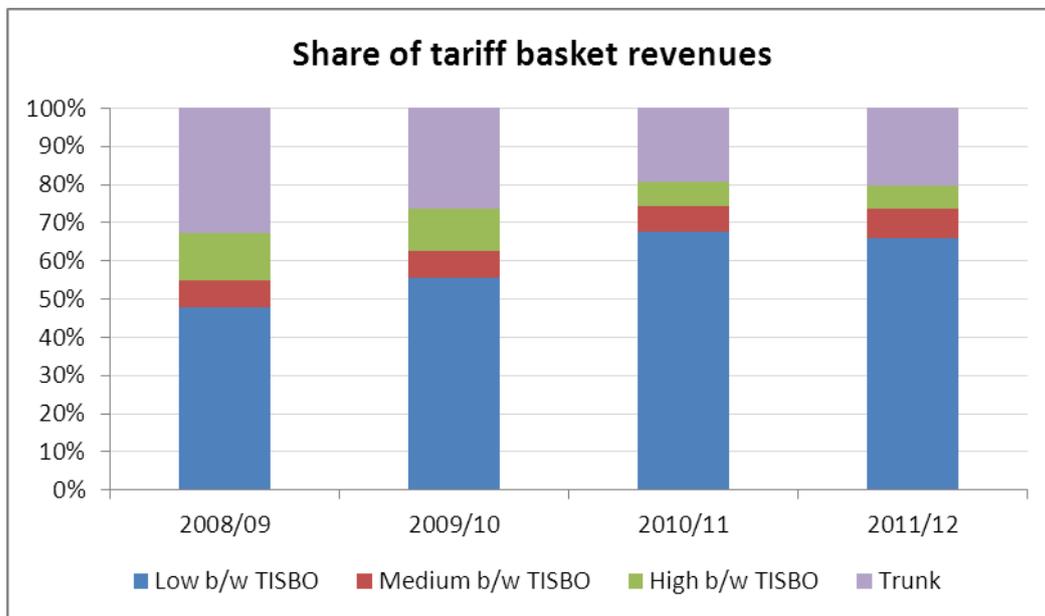
<sup>73</sup> Relative volumes of sub-products within each group have been estimated using published data from BT's RFS. Price changes compare average charges in one year with average charges in the preceding year, except for the 2009/10 charge control year where average charges are compared with charges at the beginning of the year, in order to reflect Starting Charge Adjustments under the control.

**PRICE RISES HAVE BEEN FOCUSED ON SERVICES WITH A RISING SHARE OF REVENUES**

14.4 Over the same period, revenue trends have also been non-uniform. In broad terms:

- a) low and medium bandwidth TISBO services have accounted for a rising share of tariff basket revenues; and
- b) high bandwidth TISBO and trunk services have accounted for a falling share of tariff basket revenues.

14.5 The graph below summarises our estimates of tariff basket revenue shares, by financial year, based on BT’s published pre-discount charges<sup>74</sup>:



**WITH PRIOR YEAR BASKET WEIGHTS, THIS HAS INFLATED CHARGES AND ALLOWED COST OVER-RECOVERY**

14.6 Since the 2009 control uses prior year revenues, rather than current year revenues, to weight baskets:

- a) the price rises imposed on low and medium bandwidth TISBO services, which have accounted for a rising share of revenues, have been given a lower weight than would be the case under a current year revenue approach; and

<sup>74</sup> Volumes of sub-products within each group have been estimated using published data from BT’s RFS.

- b) the price falls allowed on high bandwidth TISBO and trunk services, which have accounted for a falling share of revenues, have been given a higher weight than would be the case under a current year revenue approach.
- 14.7 As a result, the prior year based weighted average increase in prices which is subject to control, has been understated for every year in the control, relative to the actual weighted average increase that would be calculated using current year weights.
- 14.8 The use of prior year basket weights, together with a set of circumstances which has seen price rises focussed on services with a rising share of revenues, has therefore allowed inflated average price increases, and inflated charges, during this price control. Other things being equal, this will have allowed BT to over-recover its costs, relative to the level intended at the setting of the current price control.
- 14.9 We have estimated the impact of this effect by comparing the weighted average increase in prices under both a prior year approach and a current year approach, for each year of the charge control. Our analysis suggests that the prior year approach has resulted in average price increases being inflated by:
- a) 2% in 2009/10;
  - b) 3% in 2010/11; and
  - c) 1% in 2011/12.
- 14.10 The cumulative effect of these inflated increases equates to an unwarranted cost over-recovery of nearly £70m over the three year course of the price control.
- 14.11 We raised a closely related concern in the consultation process for the existing control<sup>75</sup>. Ofcom acknowledged in its Statement that such a concern had merit in principle:
- “There is a more general concern, however, that a charge control that uses prior year revenue weights could still provide scope for gaming where the weights are erratic from year to year...*
- For example, if at the start of the charge control a leased lines service, (“service A”) has a low prior year revenue weight then the regulated firm could increase price of that service significantly in Year 1 without breaching the price cap. This is because, using prior year weights, the price rise would not have a large weight in the calculation of the overall basket price change. In the second year, it may be the case that Service A now has a much higher revenue weight, therefore the company could not impose further price increases.”<sup>76</sup>*
- 14.12 However, Ofcom considered the risks to be modest, and so declined to put any specific safeguards in place, beyond some relatively high level sub-caps:

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<sup>75</sup> 3.120, July 2009 Statement

<sup>76</sup> 3.125, July 2009 Statement

*“For the TI Basket the demand forecasts for these services suggest that high levels of volatility in revenue weights for the components in the basket are unlikely. The risk of gaming of the charge control therefore appears relatively small. We have in any case included a safe-guard cap on TISBO services which will limit BT’s ability to raise the price of terminating segments within the overall TI Basket. We have also limited the permitted real increase in the price of individual service items in each year to RPI+5%.”<sup>77</sup>*

- 14.13 The experience of the current price control clearly demonstrates that Ofcom was wrong to dismiss the risks associated with the use of prior year weights (whether or not created by volatility and/or deliberate gaming), and that its safeguards were inadequate.
- 14.14 Cable&Wireless Worldwide submits that customers need much higher levels of protection against the risks created by prior year basket weights under this price control. Ofcom, however, proposes to *reduce* levels of protection, by withdrawing the cost orientation obligation<sup>78</sup>.
- 14.15 Ofcom has a number of levers at its disposal to provide these higher levels of protection, including:
- a) the use of in current year basket weights;
  - b) instead, in order to retain the stability of being able to set charges in advance with the knowledge of relevant revenue weights the weights could be based upon ‘prior six months.’ This approach would significantly reduce the opportunity to gain compared with the current system that uses data from the previous financial year; and
  - c) a tightening of sub-caps to further limit the scope for large gaps between price rises for some services and price falls for others.
- 14.16 Cable&Wireless Worldwide considers that Ofcom does need to change its approach on this issue. While we understand the problems with the use of current year weights it does provide the best solution to overcome the problem. We consider that either options a) or b) would provide a material improvement compared with the use of prior financial year weights.

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<sup>77</sup> 3.125, July 2009 Statement

<sup>78</sup> 5.12

## 15 ANSWERS TO LLCC QUESTIONS

***Question 1: Do you agree with our proposal to use an RPI-X form of charge control? If not, please explain why and propose an alternative approach with supporting information.***

15.1 Yes Cable&Wireless Worldwide supports this form of control.

***Question 2: Do you agree with our proposal for the charge control to run for a maximum of three years from the date of implementation? If not, please explain why and propose an alternative approach with supporting information.***

15.2 Cable&Wireless Worldwide agrees with the approach that Ofcom adopts when modelling a charge control over a three year period. However this will be the second leased line charge control that has not been implemented in time to run concurrently after the expiration of the previous control. We consider that Ofcom must take practical steps to both improve its ability to impose concurrent charge controls and build in the necessary safeguards to bridge any potential gaps in the future. The bridging arrangements should be agreed well in advance and not negotiated at the last minute as we believe any safeguards agreed in haste typically favour BT, with Ofcom far too eager to agree to an outcome that merely seeks to preserve existing pricing, thus delaying the onset of efficiency savings and providing additional and unplanned commercial benefit to BT, benefit that cannot be reversed. Up until now the cost orientation obligation has acted as a safeguard in this bridging period and if were to be removed then the industry would be exposed with no regulatory leavers in place to ensure that pricing for consumers was appropriate.

***Question 3: Do you agree with our overall proposal for the design of the charge control? If not, please explain why and propose an alternative approach with supporting information.***

15.3 While we are familiar with Ofcom's proposed charge control structure and the basket and sub-cap restraints within it, we cannot endorse the proposed design in the absence of a cost orientation obligation. Taken together both remedies act effectively to constrain pricing to acceptable levels, promoting efficiency in charge controlled services while simultaneously providing a basic safeguard at an each and every charge level. These regulatory remedies act as an imperfect substitute for an effectively functioning market, as BT's opportunities to game pricing to favour its own business are limited. With cost orientation removed, BT's opportunities to game pricing are significantly enhanced, with the current proposals for basket and sub-cap design unable to counteract BT's market power, resulting in consumer detriment. In the main body of our response we have highlighted some examples of where BT is able to game the proposed control, these examples are by no means exhaustive and at this stage it would be naive of us to assume we could identify all potential adverse impacts that stem from Ofcom's proposed charge control design. With cost orientation retained we would have a degree of comfort that any adverse impacts steaming from the proposed charge control design would be constrained. In the absence of cost orientation Ofcom would need to redesign the current

charge structure to be far more prescriptive than it currently is, but even then it would fail to provide the same level of dynamic assurance that cost orientation provides.

- 15.4 Indeed, if Ofcom pushes ahead with the removal of the cost orientation obligation and accompanying regulatory accounting obligations it is highly likely that we will remain ignorant of many of the adverse effects of the control as we will be devoid of data to enable us to review the impacts and effects upon us.
- 15.5 We consider that the regulatory reporting obligations remain relevant even absent the cost orientation obligation. This data is necessary to keep both Ofcom and CPs sufficiently informed both during a charge control and in the stakeholder debate ahead of the establishment of future charge controls. Without the regulatory accounting obligations it is likely that future consultations will contain even more redacted data concerning BT's operations. We would already argue that a proportion of our ability to fully engage in the consultation on areas where numbers are redacted compromises the nature of the consultation. Should BT be required to provide Ofcom data for the sole purpose of formulated future charge controls we have no doubt that BT would regard much of the data as confidential, as this seems to be their standard response when asked to provide detail beyond the level of disaggregation found in the RFS. Furthermore, experience has shown that data not regularly used or visibly to other Communications Providers is more likely to be either wrong or misleading.

#### **TREATMENT OF DISCOUNTS**

- 15.6 Ofcom does not propose to allow discounts to contribute to BT's compliance with the charge control and we agree with Ofcom's analysis on this issue. However discounts provided in the base year will be taken into account in assessing Ofcom's starting revenues in order to set the value of X. We do have concerns with this latter proposal.
- 15.7 The discounts BT applies are temporary in nature and therefore there is the possibility that BT could significantly reduce the overall level of discount after the control is set. There are certainly risks for future charge controls if BT were to put in place significant discounts specifically in order to gain the benefit in the charge control outcome. Our perspective on this is very dependent upon materiality. Ofcom has told us that the discounts give rise to a reduction in the value of X of less than 1%. We consider 1% to be quite significant, it provides BT with over £13m of additional revenue over the control period and that would warrant a closer consideration of the risk of those discounts being removed. However if 'less than 1%' means substantially less than 1%, less than 0.5%, then we can accept Ofcom's approach as we agree it is unlikely that discounts will be removed altogether. However we consider Ofcom should make it clear that it would take a different view on discounts in the future were they to be more significant.

**Question 4: Do you agree with our proposals for TI, specifically: basket design; anchor pricing approach; base year adjustments; and forecasting assumptions? If not, please explain why and propose alternative approaches with supporting information.**

#### **ANCHOR PRICING FOR TI**

15.8 We agree with Ofcom that for TI services that Ofcom's established anchor pricing approach is appropriate.

#### **BASE YEAR ADJUSTMENTS**

15.9 Now that the RFS for 2011/12 are available Ofcom should update its model inputs to reflect the availability of this more relevant data, it would be inappropriate to set the charge control on 2010/11 RFS material, which includes data back to April 2010, data that would be almost three years old if the control commences in April 2013.

#### **FORECASTS FOR TI**

15.10 We believe Ofcom's forecasts for TI volumes, particularly on 2Mbit/s, are understated. The forecast for 2Mbit/s services show they will reduce by 54% by the end of the control whereas we expect the decline to be about 40%, whilst it is possible our demand profile will not match overall demand as we are BT's biggest external customer of PPCs we are surprised by such a difference.

15.11 It is relevant that some big users of PPCs do so because of the particular characteristics of the service and their requirements mean they do not have any realistic alternatives. The fact that sub 2Mbit/s service are being withdrawn in 2018 will mean some of the customers using them will in fact switch to 2Mbit/s within the timescales of this control because the 2Mbit/s service will continue to be around for longer.

#### **BASKET DESIGN**

15.12 We will not reiterate the arguments we set out in our answer to question 2, however it is clear that our view of the proposed basket design turns on Ofcom's decision to retain or remove cost orientation. As it stands there is a significant risk that charges will move well out of line with cost.

15.13 In the absence of cost orientation Ofcom's proposed basket design is far too wide, indeed the baskets are broader than those used in the 2009 control, when cost orientation was also imposed, this is in direct contrast to the proposals for the future control which leaves POH, mobile services and infrastructure services and ancillary services without sub caps on each charge. In the section 4 of this response we have provide a detailed review of the proposed basket design and the flaws which we believe required to be addressed.

## COMMON COST TRANSFER

15.14 We do not consider the approach to forecasting captures the movement of common costs properly given the significant changes in volumes. Ofcom has addressed this in part but the adjustments do not go far enough. In section 12 of this response we discuss this issue in some detail.

## RAV ADJUSTMENT

15.15 Ofcom proposes to include the RAV adjustment on both copper and the duct used by fibre in this control; this is a change of approach from the last control that was set in 2009. In our view Ofcom is correct to make this change, we consider it was incorrect not to make the adjustment in relation to duct used for fibre in the last control because in reality the fibre used by products in these markets does make use of pre 1997 duct.

15.16 In addition, since the last charge control was set BT has changed its valuation method for duct and we are unconvinced by the extent and justification of this change. In the WLR and LLU charge control statement Ofcom has applied a RAV adjustment on both Pre and post 1997 duct. The services in these business connectivity markets use the same duct and LLU and WLR and therefore we agree with Ofcom's approach to include both of these adjustments.

***Question 5: Do you agree with our proposal for Ethernet, specifically: basket design; modern equivalent asset approach; base year adjustments; and forecasting assumptions? If not, please explain why and propose alternative approaches with supporting information.***

## MEA FOR AI

15.17 Cable&Wireless Worldwide endorses MEA cost modelling assumptions for Ethernet services, however we are surprised that the differential between the legacy and the MEA approach is not more significant, particularly in light of the lower cost of electronics and the move from dual fibre to single fibre working.

15.18 As part of the MEA approach Ofcom also proposes to make an adjustment to reflect the additional investment that would be required by BT to achieve the MEA assumptions. In fact BT's customers are already starting to move from legacy services to the MEA alternatives although we believe the rate of this move is currently being held back by the lack of suitable migration solutions. However over the course of the control many customers will make that move and Ofcom has included a forecast for that in its model and therefore has already included the costs and revenues for the majority of this migration. As a result the size of the migration credit included by Ofcom is overstated. We discuss this issue at greater length within section 13 of our response.

**BASE YEAR ADJUSTMENTS**

15.19 Now that the RFS for 2011/12 are available Ofcom must update its model inputs to reflect the availability of this more relevant data, it would be inappropriate to set the charge control on 2010/11, which includes data back to April 2010. We elaborate on the practical, economic and legal reasons for using the latest available data set in section 11 of this response.

**AI FORECASTS**

15.20 Ofcom forecasts that approximately 2/3<sup>rd</sup> of existing WES circuits will naturally migrate to MEA during the course of this control i.e. by end Sept 2015. We note however that currently it is Openreach's stated intention to close the WES platform by March 2015. Customers are being asked to move off the services by that date.

15.21 We do think Openreach target may be too aggressive, particularly given the lack of adequate migration solutions, however our view is that it will only be a small proportion of current WES circuits that remain by the end of the control. This assumption is important as in our view the AI migration credit should be calculated based upon the legacy service that are expected to remain at the end of the control under current conditions.

**BASKET DESIGN**

15.22 In comparison to the 2009 Ethernet control the proposed control results in broader baskets and greater pricing flexibility for BT. Cable&Wireless Worldwide has serious concerns which we have outlined in the section 7 of this response concerning the lack of price regulation for "multiple interface" MISBO services. Absent both charge controls and the cost orientation obligations CPs have absolutely no certainty around the pricing they can expect for a key input. Whilst the EOI obligation offers some welcome protection it falls well short of offering protection against excessive prices or indeed any unexpected vagaries of prices that BT might wish to entertain. As we have stressed earlier we expect CPs purchasing of MISBO services to differ to that of BT, with CPs using MISBO as a key backhaul service whilst BT lines of business mainly using MISBO for end user access. Absent a charge control we consider cost orientation a key safeguard.

15.23 Whilst we acknowledge that the proposed Ethernet basket design will remove an amount of excessive charging across the Ethernet portfolio overall, we disagree that the design can have sufficient foresight to prevent discrimination between services which are purchased internally and externally. It would be naive of us to assume we could identify every potential threat from the current Ethernet charge control design, however we have no doubt that BT has been afforded considerable room to game its pricing under the current proposals and in the absence of a cost orientation obligation and the accompany regulatory accounting transparency, we are far more vulnerable to this type of gaming behaviour which results in prices which are charge control compliant but likely to lead to competitive distortion and potentially excessive profit in other markets which dependent on regulated Ethernet inputs. Our ability to identify this

behaviour will very likely have been significantly compromised by the removal of regulatory accounting obligations which act to safeguard the interest of competition and consumers.

**Question 6: Do you agree with our approach and proposals for controls for excess construction charges? If not, please explain why and propose an alternative approach with supporting information.**

15.24 Cable&Wireless Worldwide has expressed concerned for some time over the level and frequency of ECCs. When looking at the cost of a single circuit it is evident that ECC can increase the standard published price by a considerable margin, adding up to a third of additional costs. We are very pleased at the focus that Ofcom has given this matter and believe it will have a beneficial impact for customers and competition.

15.25 With respect to the charge control we agree that a starting price reduction is warranted rather than a glide path over the duration of the control, as to retain ECCs at the current level for longer than necessary would be detrimental to consumers.

**Question 7: Do you agree with our approach and proposals for charge controls for accommodation? If not, please explain why and propose an alternative approach with supporting information.**

15.26 Cable&Wireless Worldwide agrees with Ofcom's proposals to regulate accommodation services within the WLA market as these services are one and the same. However there are knock on risks that Ofcom needs to consider. Recently BT has increased the cost of space offsetting this increase with a decrease in the cost of tie cables. For BCMR services however the impact is that cost increase as tie cables are not relevant for BCMR services. There is therefore a conflict between BT's, and CPs interests purchasing WLA services and CPs purchasing BCMR services.

15.27 We would urge Ofcom to consider this matter further to try both prevent and expose any potential competitive distortion in this vital service area by improving accounting transparency and limiting BT's ability to load cost onto services purchased by external customers.

**Question 8: Do you agree with our proposal for charge controls for AI services in the WECLA? If not, please explain why and propose an alternative approach with supporting information.**

15.28 Yes, Ofcom has identified that the prospect for competition is greater in the WECLA area. Leaving aside our comments with respect to the manner in which Ofcom sets the boundaries for the WECLA area, we agree that a variation in the charge control remedy such as proposed by Ofcom is sensible.

**Question 9: Do you agree with our proposal for charge controls for retail analogue services? If not, please explain why and propose an alternative approach with supporting information.**

15.29 Cable&Wireless Worldwide supports these measures. With BT's share of retail sales unchanged since the last BCMR in 2008 at 96%, it is crucial that the interests of consumers are safeguarded. A safeguard cap strikes the correct balance between protecting consumers and the practical issue of the impending withdrawal of these legacy analogue services.

**Question 10: Do you agree with our proposals for the implementation of the new charge controls? If not, please explain why and propose alternative approaches with supporting information.**

15.30 We have set out our objections to the BCMR proposal not to apply cost orientation in section 4 and the problems with the use of prior year weights in section 14. We do observe that the charge control formula itself is particularly difficult to follow and it may be that there are unintended consequences that we are simply not aware of. However aside from these issues we support Ofcom's implementation proposals.

15.31 On the assumption that final decision is taken in Q1 of 2013 we consider the requirement to correct prices to be the same by the end of year 1 as they would have been had the control started on time to be sensible one. If we have the benefit of seeing Ofcom's EU consultation proposals that will give us extra time to prepare for a shorter 28 day notice period once the final decision is made. However, it goes without saying that any significant increases in price require plenty of notice and therefore we cannot form a definitive judgment on that issue until we are sure significant increases will not result. In the event of a longer delay we would welcome further discussions on the issue.

**Question 11: Do you agree with our approach to cost forecast modelling? If not, please explain why and propose an alternative approach with supporting information.**

15.32 Please see our answers to Ofcom's previous questions and the main body of this response.

**Question 12: Do you agree with our assumptions of key inputs? If not, please explain why and propose an alternative approach with supporting information.**

15.33 Please see our answers to Ofcom's previous questions and the main body of this response.

**Question 13: Do you agree with our approach in relation to POH charges? If not, please explain why and propose an alternative approach with supporting information.**

15.34 Yes, in essence we agree with Ofcom's proposals with the exception further sub-caps should be put in place that either constrain the price of Type 1 and Type 2 handovers separately, or provide a constraint on individual charge within the sub-basket.

15.35 As Ofcom states it has only very recently concluded the PPC PoH project which has reset PoH charges. Furthermore we agree that the likelihood of additional new PPC PoH is minimal. However having reset cost recovery to an appropriate level between Type 1 and Type 2 charges respectively we believe it is important that an appropriate balance is maintained. The failure to place any further sub-caps on charges within the PoH sub basket means this is not assured. This is of particular concern given the current proposal to use prior financial year weightings as we would expect to continue to see a shift in volumes to Type 1.

15.36 We believe there are two simple alternatives to address this issue, either:

- a) Separate sub-baskets should be placed on Type 1 and Type 2 charges; or
- b) Sub-caps, of maybe RPI+5% should be placed on each individual charge within the sub-basket.

***Question 14: Do you agree with our proposals for the treatment of cost of capital? If not, please explain why and propose an alternative approach with supporting information.***

15.37 We respect the decision of the Competition Commission and Ofcom in this matter, believing that there is insufficient evidence to justify a change in approach at this stage. We do however believe that Ofcom should make reasonable efforts to ensure that decisions on Cost of Capital are made based on the most up to date information available and we should any further delays occur to this project then it may be appropriate to revisit the issue.