



OFCOM

LLU/WLR charge control

Additional TalkTalk Group submission

October 2011

INTRODUCTION

- 1 This is an additional submission by TalkTalk ('TTG') regarding certain assumptions and inputs for the LLU/WLR charge controls. This is mainly in response to (a) the additional information Ofcom has provided, (b) the meetings we had with Ofcom in late September and (c) BT's response.
- 2 We have not responded on all the areas where we have concerns. This is for two reasons.
- 3 First, there are a number of significant areas (cumulo rates, line length, non-regulated services allocation, NGA allocation, ancillary services) where we had severe concerns that were the subject of a letter by TTG to Stuart McIntosh on 5 October. We are yet to receive a response to that letter. Once we receive that response we will comment on these matters further. We expect Ofcom to take such comments into account.
- 4 Second, we will provide Ofcom further reports from Frontier and Analysys Mason regarding (principally) cumulo rates and asset valuation.

FAULTS

- 5 We note that if Ofcom is to rely on BT's claims that MPF/SMPF faults cost 20% more to repair than WLR faults due to the higher care level (MPF fix next working day rather than WLR next working day plus one) then Ofcom should provide TTG with a proper explanation of the method and assumptions that BT used so that TTG can comment on it. A 20% higher cost seems instinctively to us to be excessive given the difference in care level.
- 6 In respect of question TTG23. TTG asked as to why there are a higher level of d-side/e-side faults on MPF lines than on WLR lines since the lines are repaired to the same standard SIN349 (which fixes faults on the sub-100MHz frequency range that is used for voice). The answer (which we imagine is BT's view) appears to be that a voice+broadband user may identify sub-100MHz faults more frequently than a voice only user since though they could tolerate certain sub-100MHz faults for voice (since it might only cause a small clicking, say) they could not tolerate these faults for broadband. The consequence is that a sub-100MHz (voice) fault is more likely to be reported by a voice+broadband customer than a voice only customer. Whilst this explanation might be credible as a matter of theory it is unclear whether it is sufficient to justify the 4% higher fault level for MPF as against WLR (as implied by Fig A8.15 in Ofcom's consultation). We would appreciate Ofcom explaining what is its own view of the quantitative impact of this effect and why.
- 7 Question TTG24 raises a similar type of question (as TTG23) but in respect of frame repair. We raised two questions.
 - the MPF cost is 6.5% more than would be expected. MPF costs are 2.13 of WLR though MPF uses twice the amount of frame (due to double jumpering). Thus

one would expect the fault cost difference to be 2.00 times WLR not 2.13 of WLR

- the SMPF cost is 29% less than expected. SMPF uses one jumper so one would expect it to have the same cost as WLR – yet it is 0.71 of WLR

8 Ofcom responded that “*We believe the actual fault rate incidence is slightly higher for MPF as there are more potential points of failure on MPF compared with WLR*”. This fails to answer the question – MPF has twice as many jumpers and so points of failure as WLR not 2.13 times as many points of failure. Ofcom has not responded to the SMPF question.

9 Based on the above we await Ofcom’s answers to:

- Basis for 20% higher fault repair costs due to differing care levels (if Ofcom is to reply on this in any way)
- TTG23 – what is Ofcom’s own view of the quantitative impact of the effect and why
- TTG24 – can Ofcom explain the anomalies in frame fault repair (else adopt the logically correct usage factors of: WLR – 1.00; MPF – 2.00; and, SMPF – 1.00 (in the case of double jumpering)).

BT CORPORATE OVERHEAD

10 We have a number of outstanding concerns. These are explained below.

11 First, it is unclear what proportion of BT Group costs are allocated to Openreach. In particular, Ofcom claim that 43% of ‘Corporate Overheads’ (Consultation Table A8.2) are allocated to Openreach (which equates to £123m in 09/10). We pointed out that this was inconsistent with the FTE allocation basis that would have allocated about 30% to Openreach. When asked about this inconsistency and a desire for a breakdown of the corporate overhead cost and % Openreach allocation (by Group HQ, CTO, design costs and vacant property) Ofcom said (TTG10 and TTG11)

The figure of 43% was calculated based on a cost transfer figure stated prior to an adjustment made by BT. After this adjustment is taken into account, the actual cost transferred to Openreach in the cost calculations was reduced to £141m in 09/10 (see Figure 8.3). As a percentage of the total BT Group cost, this amount is similar to the proportion of Openreach staff to total BT Group staff.

The average is around 43%. We do not have the disaggregated % but will speak to BT about what further information we can provide.

12 This is simply unclear – for instance:

- we do not know what the adjustment is, how much it is or why it has been made

- Ofcom's answer indicates that the allocation to Openreach after the adjustment was £141m. Yet the consultation shows that the allocation to Openreach is £123m

- 13 In reply to TTG/Sky's letter of 3 October Ofcom said: "*We will be unable to provide more detail than appears in the Condoc*". All we request is a few simple and consistent numbers that have some cogent reasoning behind them – providing inconsistent and incoherent data cannot constitute proper consultation. We await Ofcom's answer¹.
- 14 Second, we have requested a breakdown of the Group HQ cost (question TTG11) so that we could calculate a more appropriate allocation (rather than the simplistic and excessive allocation based on FTE) and in particular whether the alternative approach would result in a material change. Ofcom replied that: "*We consider that [the existing] level of disclosure is sufficient*". However the level of disclosure provided is not adequate for the reasonable purposes that TTG have. It is worth noting that if Ofcom maintain its approach of using FTE as the allocation basis for all these costs and TTG consider that the resulting error is material then Ofcom will effectively be forcing TTG to appeal in order to gain information disclosure to be able to pursue its case (since in an appeal a confidentiality ring would be set up). That surely cannot be a sensible route to take.
- 15 We note in respect of this area that there can be no question of lack of time for Ofcom to complete this analysis itself or provide such data to TTG. In TTG's letter to Stuart McIntosh on 20 August 2010 (i.e. over 12 months ago) we clearly flagged the need for this data. For example: "*On allocation we think a more granular breakdown of group overhead costs will be important so that Ofcom and stakeholders can assess, for instance, whether a cost is (less) relevant to Openreach (given its non-retail and semi-independent status) and/or overseas subsidiaries, the appropriate allocation basis and how the allocation might change over time*". We repeated this request in April when we submitted our questions (question TTG11).
- 16 Regarding the definition of the FTE figure that is used for allocation Ofcom says in its reply to TTG/Sky's letter of 3rd September that the FTE includes overseas staff. This seem out of kilter with previous definitions. We would appreciate Ofcom confirming whether all FTEs employed overseas (including those working for BT's overseas subsidiaries as well as those working for, say, BT Retail but based on call centres located overseas).

¹ For avoidance of doubt, we wish to know, for each of Group HQ, Group CTO, Design Costs, Vacant Property (a) the £ cost allocated to Openreach and (b) the % of total BT Group cost allocated to Openreach

EFFICIENCY

- 17 BT made a number of comments regarding the efficiency assumption. We respond to these here and also provide an amended view of the appropriate efficiency assumption in light of BT's response and other information that has been provided.
- 18 BT in its response suggests that Ofcom should not deviate from the CC's efficiency decision in the 2009 LLU appeal of 3.7% (which was based in part on the KPMG report) and/or the updated KPMG report (which suggested 2.3% to 2.6%). Frankly this is an absurd suggestion.
- 19 In the 2009 LLU Appeal the CC relied on the KPMG report (and added an adjustment for fault rate reductions) since it was the 'best of a bad bunch' of available data. Fortunately there is now a far better body of relevant information available including the Wyman report, Openreach's medium term plan (MTP) and several years of historic data. Further it is plainly obvious that the KPMG report is partial – in particular, it excludes
- efficiency gains from fault rate reductions. Over the last few years Openreach has achieved a 2% to 3% efficiency gain solely from fault rate reductions
 - efficiency gains from productivity improvements and task time reductions. Given how inefficient Openreach's workforce is ignoring this is to disregard a huge source of efficiency gain.
- 20 To use the CC's approach / assumption from the 2009 Appeal in this charge control when there is clearly preferable evidence would be a wholly non-sensical approach. Therefore, we are pleased that in our discussions with Ofcom they reiterated that they continue to place most weight on the Wyman report as well as Openreach's MTP and historic data.
- 21 Another rather silly suggestion by BT is that Ofcom's assumption is not appropriate since regulators have set lower efficiency assumptions for other regulated utilities e.g. gas, water, rail, airports of between 1.4% and 3.8% (except 5.4% for Royal Mail). This data is spurious and of very little relevance for a number of reasons
- Openreach has achieved efficiency gains recently averaging over 6% for the last three years (see TTG Response §274) which indicates that these benchmarks are of little relevance
 - BT/Openreach will have different potential levels of potential efficiency gains compared to regulated utilities since, for instance, they may have different starting points (in terms of efficiency) and they may be more susceptible to, say, use of IT to increase efficiency
 - The data BT highlights is from decisions between 2000 and 2008 (i.e. between 3 and 11 years ago). Notably in that period BT had low levels of efficiency gain of 2% to 3% but has subsequently significantly increased them to around 6% (see TTG Response chart below §283). Thus the relevance of the data BT relies on is yet further diminished

22 The last point to note is that though BT adduced the same (even then) old benchmark in the 2009 LLU Appeal² it was not relied upon at all by the CC in coming to its decision (it was not referred to it in Determination at all). The CC also noted that if stakeholders were to rely on other regulators approaches they would need to set out (at a minimum) the rationale underlying such decisions:

We do not see that either Ofcom or CPW can reasonably rely on decisions per se made by other regulators to support or attack Ofcom's approach, at least without setting out the rationale underlying such decisions.³

- 23 BT has not set out the rationale underlying such the other regulators' decisions or why it is appropriate in this case. Further, this data is now even older and out of date than it was when it was implicitly rejected by the CC in the 2009 Appeal. This provides further reason to place no reliance on this data.
- 24 In respect of the Wyman report BT argue (at §186) that it would be inappropriate to assume that an 'efficient' operator could achieve best in class (a 5.5% cost reduction) in every cost category since there may be some trade-offs between different categories. For instance, reducing costs in one area (say staff) may require higher costs in other areas (say IT). We agree that there is some merit in this argument however, it does not suggest that the average (5.0%) is an appropriate figure to use.

- At one extreme if this phenomena (that positioning in each category was counter-correlated) were perfectly true then one would expect that the best overall level of efficiency that could be achieved would be the average (i.e. a best in class in one category would be fully offset by a worst in class in another category)
- At the other extreme if this phenomena (that positioning in each category was counter-correlated) were not true then one would expect that the best overall level of efficiency that could be achieved would be best in class in each category

25 In reality neither extreme will be true. Therefore, the appropriate figure from the Wyman report to apply to BT lies between the average (5%) and the best in class in each category (5.5%).

26 We also note that the best in class is defined as top quartile. We consider that best in class should be considered as best decile. Using best decline would result in a higher potential efficiency gain than 5.5% (lets say 6.0%).

27 Given these two factors we consider that the appropriate Wyman benchmark is between 5% (i.e. achieve average) and 6% (i.e. achieve top decile in every category) – a mid-case assumption would be 5.5%.

28 BT seemingly places a large emphasis on a report by E&Y that was prepared for it that purported to suggest an alternative assumption for efficiency gain for

² See Witness Statement Shurmer I (amended) §128ff.

³ 2009 CPW/TTG LLU Appeal CC Determination §2.384

Openreach based on modifications to the Wyman report. E&Y concluded that the potential efficiency gain was 1.9% to 2.6% (excluding, according to Ofcom, frontier movement). However, BT is at vague about the method or assumptions used to come to this result – it appears that all the relevant detail has been redacted.

- 29 We do not consider that Ofcom can rely on this information unless it (or BT) discloses the basis / method in the report so that other consultees can comment on it particularly regarding its reliability and relevance. If Ofcom did rely on this information but did not disclose it prior to the Statement then there would effectively be no consultation on it.
- 30 We further note that BT seems to have been misleading in its presentation of this E&Y data since it suggests that this data could be used as a benchmark for what Openreach might be able to achieve even though the E&Y data excludes frontier shift. BT say (at §171):

Openreach has commissioned E&Y to independently review the calculations that should be taken to estimate Openreach's relative efficiency to the industry "peer average" and it concludes that an appropriate efficiency target is the range of 1.9% to 2.6% per annum for this charge control

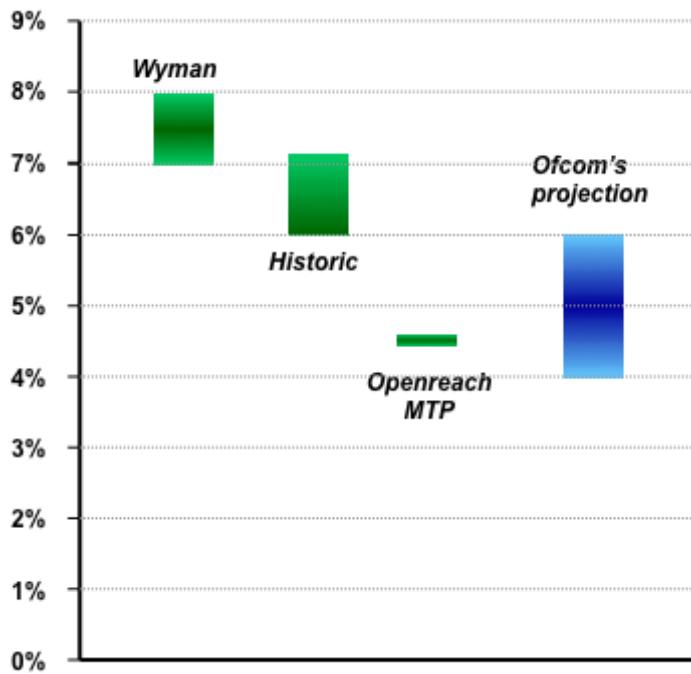
- 31 This is simply not the case – the appropriate efficiency benchmarks to use to set the assumption in the charge control should include frontier shift i.e. be 3.9% to 4.9%
- 32 We consider that the appropriate (apples to apples) benchmark data is as follows:

	amount	gross / net	Incl / excl frontier ⁴	Gross incl frontier
Wyman	5.0% - 6.0%	gross	Excl	7.0% to 8.3%
History	>6%	gross	Incl	>6%
Openreach MTP	4%	net	Incl	4.5%
KPMG	2.3% - 2.6%	gross	Incl	2.3% - 2.6%
NERA	2%	gross	Incl	2%
E&Y	1.9% - 2.6%	gross	Excl	3.9% - 4.9%

- 33 Below we provide a graphical comparison of the various relevant benchmarks. We have excluded the KPMG and NERA benchmarks since they are partial and, as Ofcom agree, are of very limited weight (see TTG Response §310). We have excluded the E&Y data since we are wholly unsure of its reliability or relevance.

⁴ KPMG estimate the frontier movement as 2.0% to 2.3% - see KPMG report for Ofcom 'Efficiency Review of BT Openreach' at §3.8.1

OPENREACH GROSS EFFICIENCY GAIN



- 34 We consider that the appropriate assumption is 6% to 8% (i.e. low-end of historic to near top-end of Wyman). We consider that the Openreach MTP is likely to systematically underestimate likely efficiency gains (see TTG Response §310).
- 35 We consider that Ofcom's proposed estimate (4% to 6% gross) may be too low since it did not ensure that the benchmarks on which it was relying were suitably rebased (i.e. to include frontier shift). For example in Figure A7.1 it shows the Wyman data as 5% to 5.5% which is incorrect since this data excludes frontier movement.

WAGE INFLATION

- 36 BT (in its response at §160) argued that wages should rise at 1% above RPI so that, during the charge control period (when RPI is forecast at 3%) wage inflation should be 4%. BT noted that wages had risen 1.4% above RPI (based on ONS data). We consider a 4% increase to be a significant over-estimate. We explain why below.
- 37 Link to RPI. Whilst over the long term it may be appropriate to calculate nominal wage rises as RPI plus a fixed 'real' inflation amount we think that in tumultuous economic periods this relationship breaks down. For instance in last 2 years real (versus RPI) wage inflation has been *negative* 1% to 2%. BT seem to accept the lack of linkage – for instance, they said in the 2009 LLU Appeal:

BT's pay deals, including those of Openreach, are not linked specifically to published RPI as CPW's appeal suggests. In fact, they are set in absolute terms as fixed percentage increases⁵.

⁵ Witness Statement of Christopher Esslin-Peard §11

38 BT highlighted⁶ that the implied real (versus RPI) wage increases from recent pay settlements were volatile:

- 07/08: +1.2%
- 08/09: +0.2%
- 09/10: -2.0%

39 Further, at the moment the (high) RPI index is not necessarily a good indicator or cost changes for households.

40 Catch-up. BT agreed a wage settlement of 3% increase per year in each of 1 Jan 2010, 1 Jan 2011 and 1 Jan 2012. This settlement (cumulatively 9%) is significantly ahead of market average which was cumulatively about 5%⁷ over the same period.

PRIVATE SECTOR PAY SETTLEMENTS⁸



41 One would expect (all else being equal) these excessive rises in BT wages to be 'caught-up' (or recovered) in subsequent years and BT's above average wage increases to be reversed.

⁶ Witness Statement of Christopher Esslin-Peard table below §12

⁷ From Bank of England Inflation Report August 2011 (Chart 4.9): 1.5% in 2010, 1.5% to 2% in 2011. TalkTalk estimate wage inflation at 2% in 2012 (aggregate of 5%). The telco sector increases have been below this level: 0% - 1% in 2010, 1-2% in 2011 and 2% in 2012 (aggregate of 4%)

⁸ Bank of England Inflation Report August 2011 (Chart 4.9)

- 42 Economic outlook. Future wage inflation is likely to be held down by the weakening economic outlook. In particular there is likely to be a lower sustainable economic growth rate which will lead to lower total enterprise returns and so reduced returns to labour and reduced wage inflation⁹. In addition wage inflation is likely to be restricted by increasing unemployment. As the Bank of England recently noted:

The Committee's central judgement is that earnings growth is likely to pick up during the first year of the forecast period. In part that reflects the projected recovery in productivity growth. But in addition, the sustained period of above-target inflation is likely to put some further upward pressure on earnings, particularly over the early part of the forecast period. Such effects could include employees trying to recoup some of the erosion of their real incomes, or employers increasing wages in order to retain or motivate staff. And they could also reflect some drift upwards in expectations of inflation.

Offsetting those effects, however, a degree of slack in the labour market is judged likely to continue to bear down on wage growth, so that wage growth remains at or below historical average rates [3% to 3.5% long term] throughout the forecast period [to Sept 2014]. There are significant risks, in both directions, around that central judgement.¹⁰

- 43 The Bank of England considers that (up to Sept 2014 i.e. beyond end of charge control) market average wage inflation is likely to equal to or be less than 3%-3.5%.
- 44 Notably this forecast of wage increases at or below the historical averages was based on a degree of catch up for employees who had had low average wage rises for the last 2-3 years. However, this was not the case for BT since BT employees had wage rises in 2010 and 2011 about 1.5% a year above average. Thus one would expect that for BT (after the end of the current settlement) that wages would rise less than market average wage inflation. We consider below what an appropriate assumption for BT's wage inflation should be.
- 45 Assuming that the 10/11 cost is fixed as the base year we consider that an average efficient average annual wage increase for 11/12, 12/13 and 13/14 would be 2.3% per year (average of 1.5%, 2.5% and 3.0%). This would imply (if Ofcom was to model the actual 3% settlements in 11/12 and 12/13) that the wage increase in 13/14 should be 1%. This is shown in the table below

⁹ See report; Implications of Recent Economic Events for the Cost of Capital to 31 March 2014. A Report from Europe Economics for BSkyB and TalkTalk

¹⁰ Bank of England Inflation Report, August 2011 page 44

	10/11	11/12	12/13	13/14
BT's settlement ¹¹	3.0%	3.0%	3.0%	
Efficient				
I. Market average	1.5%	1.5%	2.5%	3.0%
II. BT settlement then 13/14 to achieve cumulative average	3.0%	3.0%	3.0%	1.0%

46 BT's forecasts (in Table 10 at §468) are plainly unsound:

	10/11	11/12	12/13	13/14
BT's settlement	3.0%	3.0%	3.0%	
Efficient I	1.5%	1.5%	2.5%	3.0%
Efficient II	3.0%	3.0%	3.0%	1.0%
BT 'forecast'	7.2%	4.0%	4.0%	4.0%

47 In particular:

- BT claim that their 'actual' nominal pay growth in 2010/11 was 7.2% when they had a pay settlement of 3%.
- BT's forecasts for 2011/12 and 2012/13 are not only way above average wage increases but are also above BT's own inflated settlement
- The forecast in 13/14 fails to take account that BT have paid above average pay settlements for the last three years

ANCILLARY

MPF / SMPF CONNECTION CHARGES

48 BT have argued (at §245ff.) that SMPF connection (aka SMPF connection [or SMPF New Provide] and SMPF migration) and MPF connection (aka MPF transfer) charges should not be aligned (they are currently aligned and Ofcom has proposed that they continue to be aligned). BT point out that the 13/14 FAC costs estimates are different:

- MPF Transfer £37.03
- SMPF Connection £29.87
- SMPF Migration £34.55
- Average¹² £32.35 (used to set 13/14 price)

¹¹ The BT settlement is at January whereas the modelled years begin in April. For convenience we have mapped the 1 Jan 2010 settlement to financial year 10/11 (i.e. Apr 2010 to Mar 2011) and so on. This provides a reasonable match

49 BT's reasoning for non-alignment is that alignment will result in MPF Transfer and SMPF Migration FAC charges (i.e. £32.35) being below cost and so 'may result in inefficient extra demand'. BT also claim it will result in similar difficulties for the bulk variants. We do not agree that non-alignment would be appropriate for the following reasons:

- Some of the cost difference (about £5¹³) results from use of inefficient single jumpering for MPF. If Openreach acted efficiently (as it is required to do by regulation) then the cost difference would be zero. Thus it is not appropriate to include any cost difference relating to jumpering
- Some of the cost difference seems to emanate result from a cost difference of about £2 in service centre costs. We do not believe there should be any cost difference and Ofcom has not provided any reason for a cost difference. Thus absent this information we do not think any cost difference should be assumed for service centre costs
- The charges are currently aligned (and have been for several years) and so currently charges and costs are inconsistent. However, Openreach has not pointed to any evidence of inefficiency resulting from this inconsistency
- Alignment will create better efficiency incentives for BT and reduce the advantage it gains from its abusive behaviour. In particular alignment will:
 - It will reduce the advantage¹⁴ BT enjoys by configuring MPF in an inefficient manner. Configuring MPF in an inefficient manner advantages BT because BT does not use MPF itself – see TTG Response §85
 - It will remove the benefit it gains from gaming cost allocations by allocating excessive levels of cost to MPF (such as, apparently, in the case of service management costs)

ENHANCED CARE AND EXPEDITE PROVISION/REPAIR SERVICES

50 BT argue (at §263ff.) that products/services that are not part of the 'core' service should not be price regulated since they are 'enhanced', 'value-added' and/or 'discretionary' products (and, in some cases, contestable). BT apply this reasoning to argue for no price regulation to apply to higher care levels and expedite services.

51 We consider that there argument is unsound. We explain why below:

¹² The estimated 13/14 volumes (from Consultant Figure A6.1) are: MPF Transfer 1,140k, SMPF Connection 2,330k, SMPF Migration 200k

¹³ Ofcom has provided costs for MPF New Provide and SMPF New Provide i.e. SMPF connection (question TTG55). Excluding cost of routing and records (which is not relevant to MPF Transfer (or SMPF New provide)) the cost differences are about £7 - MDF Hardware Jumpering (~£5) and service centre - provision for LLU (~£2). The £7 difference is the same as between MPF Transfer and SMPF New Provide. Thus we think it provides a good breakdown of the cost difference between MPF Transfer and SMPF New Provide.

¹⁴ We suggested that alignment of costs for MPF rental and WLR rental would address the incentive to prejudice MPF (see TTG Response §107ff.).

- 52 First, these higher service levels are not discretionary in the real world. For some customers (e.g. business) and downstream services (e.g. data) high service levels are a necessity. This is increasingly the case as LLU is used to deliver business critical services (e.g. site connectivity) and as Internet access is becoming more critical. That high service levels are critical for data services is evident from the fact that a 5 hour fix is offered as standard for EAD and WES.
- 53 Second, these higher service levels are offered as standard for leased lines / Ethernet (and are price regulated). Therefore, to ensure a level playing field and avoid competitive distortion between LLU and leased lines it is necessary to price regulate the higher service levels for LLU to ensure consistency of approach and consistency of costs/charges. For example, EAD and WES is offered with 5 hour fix as standard (and is price regulated) – this is better than care level 4 (which offers 6 hour fix). Without price regulation of high service levels BT will inflate the cost of enhanced care in order to prevent cannibalisation of its leased line / Ethernet services.
- 54 BT reason that if a service is ‘discretionary’ price regulation is inappropriate. By this same reasoning, there would be no need to price regulate basic MPF since MPF is discretionary because IPStream and WLR could be used as an alternative. The question about whether something should be price regulated should not turn on an assessment of the vague notion of whether something is ‘discretionary’ or not but rather whether price regulation will meet consumer interests and, in particular, allow effective competition.
- 55 Third, we do not consider that the WLR approach (where enhanced care levels are not price regulated) has much bearing on the correct approach for LLU. In particular, the higher care levels are mostly necessary for data services (as can be provided using LLU or leased lines). WLR is obviously not used for provision of data services.
- 56 In any case, as the CAT recently highlighted in the 080 dispute appeal, Ofcom should not adopt a position merely because it is the *status quo*. The CAT considered that in selecting a particular option for 080 regulation Ofcom inappropriately relied on maintaining the *status quo* – it said:
- “[Ofcom’s approach] involves an undue pre-disposition in favour of the *status quo*, to the detriment of other legitimate interests”¹⁵
- 57 Lastly, changes in pricing structure such as SFI2 are possible within a basket structure thus price regulation (whether cost orientation or a basket control) is not a barrier to innovation.

SFI CHARGES

- 58 BT argue that SFI charges should not be price regulated (in any way) since they are (all) ‘outside the market’ (BT Response at §273). We do not consider that this is correct. We explain below.

¹⁵ British Telecommunications Plc (Termination Charges: 080 calls) v Office of Communications (Case number: 1151/3/3/10). Judgement 1 August 2011. §449

59 Some of the SFI products (e.g. frame or network modules) are to repair (within BT's network) the above 100MHz portion of an SMPF/MPF line. Broadband uses the frequency range above 100MHz. It cannot logically be right that SMPF/MPF which are used to provide broadband services are in the market yet the repair service for that product sits outside the market.

60 In respect of SFI modules that are related to components that are not strictly part of BT's network (e.g. customer premise wiring) in reality CPs have little realistic choice but to rely on BT. This is because fault diagnostic and repair will involve simultaneously and iteratively checking and repairing BT's network and customer premise wiring. For a CP to provide the customer premise element themselves will involve two truck rolls and excessive cost versus Openreach providing both parts.

61 In effect one can imagine that SFI services constitute a 'technical area' in the same way that co-location is (for instance, see WLA Market Review Dec 2004¹⁶). A service is considered as a technical area if, though not strictly in the market, it is necessary to allow a remedy in the market to be effective. In this case regulation is applied. The Commission guidelines on technical areas is as follows:

"...In dealing with lack of effective competition in an identified market, it may be necessary to impose several obligations to achieve an overall solution. For instance, it may often be the case that adjacent or related remedies are applied to technical areas as part of the overall obligation that addresses SMP on the analysed market. If specific remedies are thought to be necessary in a specific narrow technical area, it is not necessary or appropriate to identify each technical area as a relevant market in order to place obligations in that area. An example would be where an obligation to provide unbundled access to the local loop is complemented by related obligations concerning access to co-location facilities."

62 We consider that the same reasoning applies to SFI services not related to BT's own network and therefore, even if it were considered that they were not part of the market, it would be appropriate to price regulate them.

63 In summary

- Certain parts of SFI are clearly absolutely necessary and within the market since they relate to repairing part of BT's own network to allow broadband to function
- Even for those elements of SFI which are not on BT's network, CPs do not, in reality, have the 'discretion' whether to purchase from BT. Therefore, it is appropriate to regulate them

64 As we explained in our initial response (at §468ff.) price regulation is wholly appropriate to prevent excessive charges on SFI. We recommended there that SFI formed part of a basket with TRCs. The reason for this approach included:

¹⁶

<http://stakeholders.ofcom.org.uk/binaries/consultations/rwlam/statement/rwlam161204.pdf>. Explanation of a technical area can be found at §4.78ff.

- SFI/TRCs are material (over £100m)
- They are (as Ofcom accepts) mostly non-contestable
- Charges are above efficient cost
- Other regulatory obligations (such as cost orientation) are insufficient to prevent excessive charges
- The charge alignment requirements will not prevent excessive levels of charges
- Reduces BT's incentive to game cost allocation which harms competition

ELECTRICITY CHARGES

65 BT (at §408) argue that electricity charges should not be price regulated. The (only) reason they give is that electricity charges 'fall within the remit of Ofgem and not Ofcom'. This is plain nonsense for several reasons

- There is a large portion (~40%) of Openreach's electricity charge that relates to a mark-up for BT's own relevant activities and costs that is clearly nothing to do with Ofgem
- The other portion of the Openreach electricity charge is the 'raw' energy cost/price. Ofgem does not price regulate this product and the prices BT pay to electricity retailers are free from regulation. Instead Ofgem regulates some costs that electricity retailers pay (e.g. wholesale distribution, wholesale transmission)
- Even if Ofgem did directly price regulate the 'raw' energy price and there was no mark-up (neither of which is true) this would not remove the need for price regulation by Ofcom since to avoid Openreach setting prices above cost

66 In our first response we provided clear and strong reasons as to why electricity charges should be price regulated (TalkTalk response §487ff.). In our meeting with Ofcom, Ofcom indicated that (instead of a basket control) they were considering a 'voluntary commitment' from BT in relation to electricity charges. In its letter to Ofcom of 3rd September TTG (and Sky) noted that they would need to understand what this voluntary commitment was so that we could comment on its possible efficacy in addressing potential abuse. Ofcom replied that "*we have set out proposals in march 2011 consultation and will provide a conclusion in the statement*". This is factually incorrect. Ofcom did not set out its proposals for a voluntary commitment in its consultation. In its consultation Ofcom said: "*We therefore propose to explore with BT an amendment to separately report power ... in its financial statements*". This cannot be plausibly be described as a tangible proposal that consultees can comment on – all Ofcom said was that it would explore options, they did not specify any options. If Ofcom does proceed with a voluntary commitment without consulting on it, it will be a clear failure to consult properly. It is also notable that (if Ofcom proceeds as it suggests) there will be a clear asymmetry

since BT would have been fully consulted on the proposal yet other consultees will not have been.

OTHER ANCILLARY

- 67 BT (at §255) argue that since BT have not gamed the flexibility of charge control baskets no measures are required to prevent gaming in the future. BT's case is weak:
- The 'evidence' that they point to relates to one basket in one year
 - In any case, the question of whether to impose measures to prevent gaming should be based on the potential for gaming (i.e. whether BT have the incentive and ability) rather than requiring proof of past abuse. This was supported by the CC. In the 2009 LLU Appeal the CC determined that Ofcom had erred by not imposing measures to prevent gaming¹⁷ since BT had the incentive / ability (even though no evidence was presented of previous gaming)
- 68 BT (at §259) have argued that inertia clauses are unnecessary and they prevent prices being aligned with costs. We agree in part – provided other superior anti-gaming measures (e.g. current year weighting, alignment obligations etc) are put in place, inertia clauses are unnecessary.
- 69 In our first response we noted (at §462ff.) that MPF cease and SMPF cease costs should be equalised prior to recovering these costs from the rental charges. The MPF cease costs that BT provided were as Ofcom noted, implausibly, higher than SMPF cease costs. Ofcom considered that these costs should be the same. However, when it recovered these costs from the relevant rental charges it failed to equalise the costs (as it had indicated was appropriate). We note that neither BT nor Ofcom has presented any evidence to justify that the costs should be different.

PATH OF PRICES

- 70 In our response (see TTG Response §533ff.) we explained the perverse outcome that resulted from applying the RPI-X formula. By way of illustration if the costs of a particular product were expected to stay flat applying the RPI-X formula would result in charges increasing in the first years of the charge control only to fall back later.
- 71 We suggested a way in which this outcome could be avoided. When we met Ofcom, Ofcom requested a little more information on how it might apply for 12/13. We provide a worked example below (we can provide Ofcom the Excel spreadsheet if useful).

¹⁷ 2009 LLU Appeal Determination §3.175ff.

- 72 In essence rather than setting the price increase for 11/12 and 12/13 based on the RPI – X formula, prices for 12/13 should be based on the ‘desired price trend’. The ‘desired price trend’ reflects the starting price (in 10/11), the end price (i.e. cost in 13/14) and the trend between the two. Ofcom expects cost trends to be smooth and therefore the price trend should also be smooth.
- 73 In the worked example below the desired price change is 0.3% each year (to glide prices smoothly from 10/11 to 13/14). In 11/12 and 12/13 the price is based on this 0.3% directly. In 13/14 the price should be set through the normal RPI – X formula. In this example (lagged) RPI in 13/14 is estimated at 2.0% and therefore the appropriate X is –1.7%. If lagged RPI turns out to be higher than 2% then the change will be greater and visa versa.

	10/11	11/12	12/13	13/14
RPI lagged (from previous October)		4.5%	5.0%	2.0%
Openreach unit cost inflation		1%	1%	1%
Current price	£ 102.00			
Cost	£ 100.00	£ 101.00	£ 102.01	£ 103.03
Desired price trend	£ 102.00	£ 102.34	£ 102.69	£ 103.03
Traditional method				
X		-3.5%	-3.5%	-3.5%
RPI - X		1.0%	1.5%	-1.5%
price	£ 102.00	£ 103.03	£ 104.59	£ 103.03
Improved method				
price change to hit target		0.3%	0.3%	
X				-1.7%
RPI - X				0.3%
price	£ 102.00	£ 102.34	£ 102.69	£ 103.03

- 74 This example shows that if the traditional method is used then prices will be set far higher than they should be (e.g. £104.59 in 12/13 rather than £102.69).

OTHER

ASSET VALUATION

- 75 We concur with the points that Sky raised regarding copper prices and how these should be reflected in asset valuations (see Sky letter to Stuart McIntosh 12/10/11).

DACS

- 76 We understand that Ofcom's view is that DACS use is unlikely to decline at the rate it has previously since BT has stopped its proactive DACS removal programme. In any event, we would expect to see some reduction in DACS use as broadband uptake increases and due to natural churn¹⁸. We also maintain our position that the DACS cost appears significantly under-estimated (see TTG Response §160).

VOLUME

- 77 Clearly the original volume assumptions were incorrect – for instance, in 10/11 they predicted a fall in lines whereas in fact the volumes increased. We would appreciate seeing the modified projections so that we could comment on them.

BT NORTHERN IRELAND

- 78 Ofcom indicated that (in line with the suggestions that we made in our initial response) that it may be appropriate to allocate other costs to BTNI. We would appreciate understanding Ofcom's tentative proposals.

PRODUCT MANAGEMENT

- 79 We note that in its response to TTG27 Ofcom said that it considering altering product management LRIC costs (i.e. in particular whether costs should be adjusted to reflect that the previous presumption that MPF was more 'complex' was in fact not the case). If it is appropriate to make the alteration to LRIC costs, then so too should an alteration be made to FAC costs.

SUB-LOOP UNBUNDLING

- 80 BT argue (§228ff.) that it should be able to recover certain costs that result from SLU in LLU charges. We do not comment here on the legitimacy of this suggestion. However, we do note that the current SLU product is effectively unusable since its capabilities are poor (e.g. bulk migration processes) and the provision and repair processes are manual (meaning that they are expensive, error prone and slow). The inadequacy of the product is amply demonstrated by Digital Region's lack of success. Therefore, if Ofcom was to take SLU uptake into account, based on the current situation, a very low forecast of demand is appropriate.

¹⁸ even if broadband uptake was static housemoves and churn would result in the need for more DACS removal.

TRANSPARENCY

- 81 BT argue (§51) that additional disclosure is not appropriate in cases where there are confidentiality concerns. We concur with this in the case where those confidentiality concerns are legitimate.
- 82 However, even where there are no confidentiality issues BT argue that additional disclosure is inappropriate since:
- The role of consultation is not to ‘exactly replicate Ofcom’s analysis’
 - Stakeholders have ‘more than sufficient information’
 - The level of disclosure is the deepest and most comprehensive that BT is aware of
- 83 It may seem unclear why BT is wading into this debate that has frankly nothing to do with it. However, BT’s interest is clear when one considers that BT has all the information and thus it is absolutely in their commercial interests to limit the data given to other operators in order to weaken those other operators’ positions and ability to respond intelligently to Ofcom’s consultation
- 84 In respect of their particular points:
- It is absolutely necessary and appropriate for consultees to be able to fully understand Ofcom’s analysis so that it can comment meaningfully. If that requires a consultee to be able to see and replicate Ofcom’s analysis so be it. What is the point of giving a partial view when it is so easy to disclose the full view?
 - Given BT is not in a consultees’ shoes (of being continually denied relevant information) it is difficult to understand how they can conclude that consultees have ‘sufficient’ information.
 - The level of disclosure in other situations is mostly irrelevant. The question is what level of transparency is necessary for Ofcom to best meet its statutory obligations both procedurally and in terms of ensuring a high quality decision