OFCOM

Ethernet dispute draft determination

TalkTalk Group submission

Non-confidential version

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1 Introduction

1.1 This is TalkTalk Group's ('TalkTalk') response to Ofcom's Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT's charges for Ethernet services dated 9 February 2012.

1.2 TalkTalk welcomes Ofcom's proposed finding that these charges were in contravention of BT's cost orientation obligation. That said, TalkTalk have a number of concerns with Ofcom's conclusions and particularly how it has derived the amount to be repaid. In this submission we provide our reasoning and evidence to support our view.

1.3 The submission is structured as follows:

1.3.1 **Summary** (Section 2)

1.3.2 **Cost standard** explains why we consider the use of only a DSAC ceiling on individuals products is inadequate as a means of assessing cost orientation and deriving the overcharge in this case (Section 3)

1.3.3 **Interest** discusses why interest calculated using BT's WACC should be included in the repayment (Section 4)

1.3.4 **Appropriate cost data** provides our view on the cost adjustments that Ofcom has made (Section 5)

1.3.5 **Other issues** covers other comments on the Draft Determination (Section 6)

1.4 We would be very happy to provide Ofcom additional information to help in its consideration of this dispute.

2 Summary

2.1 In this section we summarise the key points of our submission.

2.1 Cost standard used to assess compliance

2.2 Between April 2006 and July 2009 BT's prices for certain WES/BES services averaged 2.5 times FAC costs[1]. TalkTalk welcomes Ofcom's proposed finding that these charges were in contravention of BT's cost orientation obligation. That said, we do not believe that Ofcom has applied an appropriate or evidenced-based approach to the cost standard and tests by which it has judged cost orientation and quantify the level of the overcharge.

2.3 Ofcom has proposed in its draft determination to interpret cost orientation as only requiring that the charge for each service should be no higher than the DSAC of that service. This test would still allow prices to be significantly above FAC (1.95 times FAC). Notably although Ofcom purports to apply DSAC as only a 'first-order' test, in practice Ofcom's analysis does not consider other tests.

2.4 Ofcom's assessment of what level of prices are compliant with BT's cost orientation obligation for WES/BES products must be based on the EU Communications Directives and Ofcom's relevant duties set out in the Communications Act 2003. The primary consideration that flows from this is that prices should be economically efficient, promote competition and thereby confer the maximum benefits on consumers. In the context of this dispute, TalkTalk believes that the particular economic efficiency objectives are:

2.4.1 In aggregate across all products BT should not over-recover its total costs i.e. aggregate revenue should equal total FAC

2.4.2 Generally prices for individual products which are close to FAC with similar mark-ups on each product will best promote efficient entry/investment and effective competition

2.4.3 Some price flexibility should be allowed to allow for improved allocative efficiency through the use of Ramsey-based pricing for some individual products i.e. higher than FAC prices on individual products that have lower elasticity. However, these higher than FAC prices must be offset by lower than FAC prices on other products to meet the overall recovery objective

2.5 In light of these objectives WES/BES prices set as high as DSAC would only be compatible with Ofcom's duties and objectives if both of the two following conditions are met:

[1] All the figures given are the average for 06/07, 07/08 and 08/09. 09/10 is excluded since not all external WES/BES charges have been disputed in this period. However, the same method for assessing compliance should apply

2.6 First, WES/BES products could be priced above FAC but only if the retail products (that used WES/BES) were more inelastic than other retail products that share common costs (e.g. duct) with WES/BES. Particularly in the case of BES this is highly unlikely in which case efficient Ramsey-based prices would be less than FAC. More generally, setting WES/BES prices at DSAC would only be allocatively efficient if the elasticity of the retail products that used WES/BES were over three times more inelastic than other retail products – this is not plausible.

2.7 Ofcom's claim that DSAC provides the 'appropriate' degree of flexibility is unjustified and (on the basis of available evidence) unjustifiable. Further, and in any case, BT has provided no elasticity evidence to justify higher than FAC prices as it is required to do by virtue of HH3.1 "*… [BT] shall be able to demonstrate to the satisfaction of Ofcom …*".

2.8 Second, WES/BES prices above FAC would need to have been offset by prices below FAC (i.e. under-recovery) on other products to avoid BT over-recovering its costs. BT/Ofcom have presented no evidence of such under-recovery elsewhere. In fact, on the basis of evidence available to TalkTalk the very opposite appears the case – BT has over-recovered on other relevant products as well and there is no offsetting under-recovery.

2.9 The evidence shows that neither of these conditions is true and therefore Ofcom's proposed approach to assessing cost orientation based on a DSAC ceiling on individual products is inadequate and insufficient on its own to determination cost orientation. The DSAC test alone gives BT far more 'flexibility' than is required to extract efficiency gains through Ramsey pricing. Further, even if DSAC were the appropriate ceiling on an individual product Ofcom's approach lacks any constraint on overall recovery.

2.10 Reflecting the economic efficiency considerations (productive and dynamic as well as allocative) and the particular circumstances of WES/BES, we think a suite of tests are necessary for assessing compliance and calculating the overcharge. Our proposed tests (which are highly generous to BT) are as follows (figures excl 09/10):

2.10.1 Ceiling on each/every individual product test set at FAC+30% which provides ample flexibility to allow Ramsey-based pricing. Overcharge = £174m

2.10.2 Ceiling on WES/BES product group test set at FAC+10% which provides ample flexibility to allow Ramsey-based pricing. Overcharge = £192m

2.10.3 Overall cost-recovery test: Since no under-recovery on other relevant products then no justification for higher than FAC prices for external WES/BES products. Overcharge = £205m

2.11 Ofcom in our view should only depart from these tests and conclusions if BT provides (as it is required to) relevant and reliable evidence regarding elasticities and under-recovery elsewhere that would justify higher prices / ceilings.

2.12 BT and Ofcom have advanced other considerations as to why prices at or above a DSAC ceiling are compliant. However, we believe these to be irrelevant and/or invalid:

2.12.1 There is no reason of precedent, expectation or regulatory certainty that should bind Ofcom to using a DSAC ceiling test alone:

2.12.1.1 it has always been plainly clear that DSAC was not the only compliance check – DSAC was a 'first order test'

2.12.1.2 it is clear that Ofcom has the discretion to adopt different/additional tests

2.12.1.3 Ofcom cannot anyway fetter its discretion by blindly following an approach it has previously adopted

2.12.1.4 on proper inspection, previous practice (regarding interconnection services, PPC and ISDN) does not support the use of DSAC alone

2.12.1.5 It would be simply absurd for BT to have legitimately expected that Ofcom would have interpreted its cost orientation obligation so as to allow it to substantially overall over-recover costs

2.12.2 WES/BES costs were reasonably predictable and, in any case, if BT felt unable to predict costs reliably and expeditiously adjust prices to align prices with actual costs then it should have erred on safe side

2.12.3 FAC based tests (e.g. FAC+30%) are more practicable than DSAC based tests

2.12.4 There is no justification for a higher allowed WACC for WES/BES products

2.12.5 Contrary to Ofcom's assertion, there is no greater cost minimisation incentive from using actual DSAC than using actual FAC (or actual FAC +30%) as the cost standard to set the ceiling. Ofcom's criticism of FAC as a form of 'rate of return' regulation is equally true of DSAC

2.13 Ofcom's approach of only applying a DSAC ceiling on each/every charge results in economic efficiency and harm to customers and so is inconsistent with Ofcom's statutory duties. Such a 'lax' approach cannot be the correct basis to interpret cost orientation.

2.2 Need to include interest in repayment

2.14 TalkTalk believes that Ofcom has erred in its provisional conclusion that interest should simply be payable in accordance with the contract (which excluded interest). The question of interest is squarely within the scope of the dispute and therefore in order to discharge its dispute resolution duties under s186 of the Act, Ofcom needs to assess whether it is fair and reasonable to award interest on the overcharged amount and if so the level of interest rate that should be applied.

2.15 Ofcom may consider that contractual rights over-ride other factors based on the CAT judgement in BT's 080 appeal ([2011] CAT 24). TalkTalk disagrees that this case provides a precedent that applies to the current case. The two cases were fundamentally different because, in the 080 Appeal, in contrast to this matter, BT did not have SMP. Even if the 080 case were relevant then the case does not in fact support Ofcom's position that contractual rights over-ride other considerations.

2.16 TalkTalk submits that it would be fair and reasonable that interest should be awarded and that the interest rate used should reflect the capital cost benefit enjoyed by BT. Ofcom has previously stated in the PPC payment term dispute that a contractual payment term can be replaced by Ofcom's own consideration of what is fair and reasonable as between the parties and that BT is not entitled to a capital cost benefit on the basis of what it has been able to include in an SMP product contract by virtue of its market position. In addition, it is abundantly clear that the current BES/WES contract in so far as the Interest Exclusion term is concerned does not represent a balanced commercial agreement between TalkTalk and BT. Nor is it compatible with Ofcom's wider statutory obligations such as ensuring that there are incentives to comply.

As to the level of interest rate that should be used to calculate the amount of interest, TalkTalk believes that the rate should be BT's WACC which best reflects the avoided capital costs that BT enjoyed and creates the best possible incentive on BT not to overcharge in breach of its cost-orientation obligation.

2.3 Other points

2.17 The other points we make in this submission are:

2.17.1 We agree wholeheartedly with Ofcom's proposal not to make the changes to the DSAC model that BT suggests

2.17.2 We agree with making correction for the volume errors though we have not been able to confirm whether the corrections are appropriate since insufficient data has been disclosed

2.17.3 We agree with most of the adjustments to FAC costs to reflect the 2009 LLCC statement (namely transmission equipment, 21CN, ancillary services and payment terms)

2.17.4 We disagree with the approach to:

2.17.4.1 Holding gains since it is inconsistent in that the revaluation is allowed (with resulting increased depreciation and ROCE costs) but the offsetting holding gain is ignored

2.17.4.2 RAV adjustment since WES services will use pre-97 assets

2.17.5 With regard to the 2009 LLCC statement adjustments we have not been able to confirm whether the corrections are appropriate since insufficient data has been disclosed.

2.17.6 The adjustment to DSACs should be based on a 50:50 mix of a proportional adjustment and absolute adjustment.

3 Cost standard

3.1 This section discusses the appropriate cost standard(s) (e.g. FAC, DSAC, LRIC, SAC) that should be used to assess compliance with BT's cost orientation obligations. Ofcom's discussion of the appropriate cost standard is in section 9 of its draft determination.

3.2 BT's prices for external WES/BES products[i] averaged 2.5 times FAC i.e. FAC + 150%. For the products / periods where prices were above DSAC the prices averaged 3.0 times FAC (i.e. FAC + 200%).

3.3 Condition HH3.1 requires:

> *"each and every charge to be reasonably derived from the costs of provision based on a forward looking long run incremental (LRIC) approach and allowing for an appropriate mark-up for the recovery of common costs (including an appropriate return on capital employed)".*

3.4 It is accepted by all parties that the appropriate cost standard should equal LRIC costs plus an appropriate mark-up for common costs (where LRIC and common costs include a return on capital employed) (§§9.7 to 9.9). As Ofcom highlights (§9.10) the question of cost standard turns on what mark-up (or allocation of common costs) is considered 'appropriate'.

3.5 Ofcom propose that the appropriate mark-up or allocation of common costs used to assess compliant prices should be based on the DSAC methodology[ii]. The output of the DSAC cost calculation is a cost figure that lies between FAC/LRIC+EPMU and an individual product SAC. In the case of the external WES/BES services the DSAC costs were on average about twice (95% more than) FAC/LRIC+EPMU costs[2] during the disputed period (see endnote (i)).

3.6 FAC and LRIC+EPMU are typically similar and FAC is a good proxy for LRIC+EPMU[3] – under the two methods the product costs are comparable since they both: use causal / incremental approaches to allocate non-common costs; allocate common costs 'uniformly' or 'neutrally'; and, ensure overall cost recovery. We refer to FAC in this submission since LRIC+EPMU figures are not available.

3.7 Ofcom has said it considers DSAC the appropriate cost standard for assessing whether charges were cost orientated. Its explanation is summarised in §9.19:

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[2] We do not know the actual level of LRIC+EMPU for the AISBO services. However, it is likely to be similar to FAC – see footnote 3. For the purpose of this response we assume that they are the same. Ofcom clearly could find out the LRIC+EPMU for the services since this is an output of BT's LRIC model. If these costs are provided then we would be happy to rerun this analysis using LRIC+EPMU costs rather than FAC

[3] Few LRIC+EPMU versus FAC cost comparisons are available though in the 2005 NCC LRIC+EPMU costs were calculated to be 1.6% higher than FAC costs (See: 2004 Network Charge Controls Statement §4.71). In Ireland FAC costs and LRIC+EPMU costs for services are typically within +/- 5% of each other

In Section 5 of the PPC Final Determinations we explained why we considered DSAC to be the most appropriate cost benchmark for our assessment of BT's compliance with the relevant condition. Our decision was based on a number of reasons including:

• the DSAC approach reflects the practical application of underlying economic theory, recognising the major conceptual and practical challenges of implementing the full-blown approach of SAC/combinatorial tests;

• in our view DSAC strikes an appropriate balance between the desire to provide BT with the incentives and flexibility to both reduce costs and efficiently recover common costs, and the desire to protect consumers and competition from either harmful or anti-competitive charges that could arise from boundless pricing flexibility;

• the use of DSAC was recognised by BT (including in its own yearly Primary Accounting Documents throughout the Relevant Period) as the approach that Ofcom would adopt for analysing complaints that charges were unreasonable "in order to avoid complex combinatorial tests" and that the DSAC represents the "maximum price that can be charged".

3.8 Ofcom also says regarding the use of FAC versus DSAC (at §9.50):

While we agree that comparing revenues with FAC can provide a useful cross-check on the results of the DSAC test, where we identify that overcharging has occurred, we consider that DSAC rather than FAC should act as the maximum level of any charge for the purposes of quantifying the overcharge. As we explain in more detail below, our view is based on:

• DSAC providing a greater degree of flexibility in pricing than FAC and therefore being the most appropriate measure based on the regulatory objectives for cost orientation;

• setting all of the charges in one market at DSAC is not necessarily inconsistent with a competitive market; and

• the use of DSAC is consistent with regulatory certainty.

3.9 These passages imply that Ofcom considers that DSAC (rather than either FAC or SAC/combinatorial) is the most appropriate cost standard to set an effective price ceiling for cost-orientation because of the following key factors:

3.9.1 DSAC represents a sensible balance of <u>economic</u> considerations since:

3.9.1.1 DSAC reflects a 'practical application of underlying economic theory'

3.9.1.2 DSAC provides incentive/flexibility to reduce costs[4]

3.9.1.3 DSAC allows incentive/flexibility to efficiently recover common costs (we presume this to mean the Ramsey pricing concept[iii])

3.9.1.4 DSAC prevents pricing that is harmful to consumers / competition

3.9.2 DSAC is better than SAC/combinatorial since it is more <u>practical</u>

3.9.3 DSAC was how BT <u>expected</u> the ceiling to be set and using DSAC provides regulatory certainty

3.10 Regarding the case of WES/BES services there are two other important contextual matters:

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[4] see also PPC Determination §5.90(d)

3.11 First, BT had clear SMP in AISBO services and so had a strong incentive to excessively price these products given the lack of competitive constraints which was the reason for imposing a cost orientation obligation[5]. BT had a market share at the wholesale level of over 78%[6]. There was also significant barriers to entry with no expectation of prospective competition or other factors constraining prices[7]. As Ofcom said in the 2004 Leased Line Market Review (§3.71):

> *… Ofcom's view is that there are no developments that would generate sufficient competitive pressures within the next 2-3 years to alter the current finding of SMP.*

3.12 Notably, BT's market share in AISBO only marginally decreased from 2004 to 2008 (by about 5 percentage points)[8] even though prices were 2.5 times FAC. This evidence reinforces the view that there was no effective competition or competitive constraint on prices.

3.13 Second, implicit within Ofcom's approach for WES/BES is that there is <u>only</u> a restriction on the price of each (and every) individual product[9]. There is, for instance, no additional (and more stringent) restriction on pricing of a wider group of products to avoid overall over-recovery of common costs. This means that, under Ofcom's approach BT could price every product at DSAC (thereby over-recovering costs overall) yet be compliant.

3.14 The lack of constraint on overall over-recovery contrasts with, for instance, the situation for interconnection services. For those services there was an additional pricing constraint since interconnection services were within a charge control basket (the network charge control or NCC) which constrained overall recovery. This meant that if BT chose to price some services above FAC it needed to offset this by pricing other services below FAC. As Ofcom said in 2001 NCC Guidelines (B6):

> *"Within a charge control basket, setting one charge near the ceiling (ie with a larger proportion of common costs between access and conveyance) will mean that other charges in the basket will need to be set nearer the floor (with a smaller proportion of the common costs between access and conveyance) to meet the requirements of the control."*

3.15 Below we discuss:

3.15.1 economic efficiency considerations (Section 3.1)

3.15.2 conclusion on economic efficiency considerations, appropriate price level and calculation of overcharge (Section 3.2)

3.15.3 other considerations including SAC/combinatorial tests, practicality, expectation / precedent, appropriate allowed WACC and cost predictability (Section 3.3)

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[5] 2004 Leased Line Market Review §§7.52-7.64

[6] Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets 2004 ('2004 Leased Line Market Review') §§3.48, 3.50

[7] 2004 Leased Line Market Review §§3.48, 3.71

[8] Business Connectivity Market Review Statement 8 December 2008 §7.126

[9] Arguably the non-discrimination obligation might affect prices but only the relative prices as between internal and external supply and not the overall level of prices

3.1 Economic efficiency

3.16 In this section we first examine the legal/regulatory context for why economic efficiency considerations should be the primary basis for assessing whether prices / cost allocations are reasonable and second what those economic efficiency considerations should be.

3.17 These issues are discussed in the Frontier report that is provided with this submission.

3.1.1 Importance of economic efficiency considerations

3.18 In this section we explain why the primary basis for assessing whether prices / cost allocations are reasonable should be economic efficient considerations.

3.19 Ofcom's approach to assessing appropriate prices must be made with reference always to the European framework and Ofcom's duties.

3.20 The Access Directive is clear that prices should be set to promote economic efficiency and competition. For example:

> *The method of cost recovery should be appropriate to the circumstances taking account of the need to <u>promote efficiency and sustainable competition and maximise consumer benefits</u>.*[10]
>
> *National regulatory authorities shall ensure that any cost recovery mechanism or pricing methodology that is mandated serves to <u>promote efficiency and sustainable competition and maximise consumer benefits</u>.*[11]
>
> *Where an operator has an obligation regarding the cost orientation of its prices …. For the purpose of calculating the cost of <u>efficient provision of services</u>, national regulatory authorities may use cost accounting*[12]
>
> *When national regulatory authorities are considering the [access] obligations … they shall take account in particular of the following factors: … the need to safeguard competition in the long term, with particular attention to <u>economically efficient infrastructure based competition</u>;*

3.21 Furthermore, Section 3(1) of the Communications Act (the 'Act') provides: "*It shall be the principal duty of Ofcom, in carrying out their functions … to further the interests of consumers in relevant markets, where appropriate by promoting competition*" (Act s3(1)). These objectives of consumers' interests and promotion of competition will be best met by pricing that is economically efficient.

3.22 The need to set/assess prices based on economic efficiency considerations (for <u>both</u> charge controls and cost orientation obligations) is reinforced in Sections 87 and 88 of the Communications Act 2003 (the 'Act') (reflecting Access Directive Art. 13).

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[10] Access Directive Rec. 20
[11] Access Directive Art. 13(2)
[12] Access Directive Art. 13(3)

Section 87 (9)

The SMP conditions authorised by this section also include (subject to section 88) conditions imposing on the dominant provider—

(a) such price controls as OFCOM may direct in relation to matters connected with the provision of network access to the relevant network, or with the availability of the relevant facilities;

(b) such rules as they may make in relation to those matters about the recovery of costs and cost orientation; …

Section 88 (1)

OFCOM are not to set an SMP condition falling within section 87(9) except where—

(a) it appears to them from the market analysis carried out for the purpose of setting that condition that there is a relevant risk of adverse effects arising from price distortion; and

(b) it also appears to them that the setting of the condition is appropriate for the purposes of—

(i) promoting efficiency;

(ii) promoting sustainable competition; and

(iii) conferring the greatest possible benefits on the end-users of public electronic communications services.

3.23 The central role of economics and economic efficiency in judging whether prices are reasonable (both in cases where charge controls and / or cost orientation applies) has been repeated and reinforced in many other decision. In relation to cost orientation, for example:

3.23.1 In the 2004 Leased Line Market Review (which is the basis for the cost orientation obligation on WES/BES products at §7.68): "*… the [cost orientation] condition is appropriate for the purposes of promoting efficiency and sustainable competition and conferring the greatest possible benefits on the end users of public electronic communications services.*"

3.23.2 CAT PPC Dispute Judgement: "*BT is not permitted to raise prices beyond those that are cost orientated, because this would be likely to cause economic harm: this was established by the anterior finding of SMP made at the time the condition was imposed. Economic harm and breach of the cost orientation obligation are, therefore, two sides of the same coin.*"[13]

3.24 On the basis of the applicable legislation and Ofcom's earlier pronouncements, it is clear in our view that whether prices are 'appropriate' (as required by the cost orientation obligation) must be assessed on the basis of whether the prices promote economic efficiency, sustainable competition and consumer benefits. This means in respect of Ofcom's proposed approach that the pertinent question is: 'will applying a DSAC ceiling alone promote economic efficiency, sustainable competition and consumer benefits?'.

[13] CAT PPC Judgement §326

3.25 In the case of charge controls, Ofcom has a well developed approach for assessing costs and the cost standard to use which is in the vast majority of cases to set the price of individual products and/or groups of products at efficient FAC (see Annex B).

3.26 We are not suggesting that a cost-orientation obligation should somehow be interpreted as imposing as strict a constraint on pricing of individual products as charge controls do. We accept that the rationale and methodology for imposing charge controls is different to cost orientation and more price flexibility may be warranted. Nonetheless, we believe that the approach adopted by Ofcom in relation to price controls is highly instructive to the case of cost orientation for two reasons. First, the approach is well established and therefore is a useful reference point for considering what might be appropriate for a cost orientation obligation. Second, according to sections 87, 88 of the Act similar approaches to analysing costs should be used for assessing costs/prices under cost orientation obligations and for setting prices in charge control situations.

3.27 Ofcom has proposed using actual DSAC as the basis for assessing cost orientation. DSAC is 95% above actual FAC (for WES/BES services) and about 115% above efficient FAC (see footnote 17). Therefore there is a very significant difference in the approach Ofcom uses in charge controls (efficient FAC) and the approach it uses in cost orientation (actual DSAC which is more than twice efficient FAC).

3.28 According to Ofcom's approach to cost orientation BT can set its WES/BES prices at double the level that which would have been allowed if a charge control applied. We are not suggesting that cost orientation should mean that FAC is the cap on the price of individual WES/BES products. Nonetheless the difference in allowed price levels is stark and warrants investigation and justification.

3.29 Below we consider the economic efficiency of using actual DSAC as the basis for assessing compliance with cost orientation obligations. It is structured as follows:

3.29.1 DSAC and economic theory

3.29.2 Incentives to minimise costs

3.29.3 Efficient entry and investment

3.29.4 Effective downstream competition

3.29.5 Allocative efficiency – Ramsey-based pricing and overall recovery

3.29.6 Evidence provided to justify prices

3.30 In Section 3.2 we summarise the economic considerations and on this basis propose what tests should be used to assess cost orientation.

3.1.2 DSAC and economic theory

3.31 DSAC is a costing method that was created by Oftel in 1997 as a means of setting a ceiling for certain network charges which were regulated through the NCC basket charge control. It is not, as far as we are aware, used in other industries or other countries.

3.32 Ofcom says that it has opted to use DSAC since: "*the DSAC approach reflects the practical application of underlying economic theory*" (§9.19). Ofcom also claim that DSAC sets the appropriate level of price flexibility (§11.41):

> *… the use of DSAC as a ceiling for individual charges provides BT with an appropriately bounded degree of pricing flexibility over how it recovers common costs across the services that share those common costs.*

3.33 It appears to us that the extent of the role of DSAC is that it could be a 'first order test' of cost orientation. We think that DSAC is not underpinned by economic theory and nor it is linked to any economic concept. DSAC is a price for an individual product that because of the way it is calculated happens to fall between LRIC+EPMU and SAC.

3.34 In contrast other cost standards are grounded in various economic concepts. For example:

3.34.1 LRIC is the incremental cost caused as a result of an increment of production of a product (and so excludes any common costs). Prices set at this level will be productively and allocatively efficient (statically). LRIC is the lowest price that would be charged in a competitive market (though it would only be appropriate in unusual circumstances e.g. extremely elastic products)

3.34.2 LRIC+EPMU are the costs in the case where common costs are recovered in proportion to the LRICs of each product. It is also the most allocatively efficient pricing if price elasticities are equal. Further, if all products are priced at LRIC+EPMU then there would be no overall over-recovery (so avoiding over-recovery which is economically inefficient). LRIC+EPMU is used to set charge in UK (e.g. MTR) and also in other countries (Ireland)

3.34.3 Even SAC/combinatorial costs have some economic underpinning (though as we explain below very little real-world relevance). They the very highest prices that could be charged for certain product(s) if all the common costs relevant to that product(s) were recovered from that product(s). As the product group expands the SAC of the product group tends to LRIC+EPMU. However, prices at SAC for individual products are extremely unlikely to be economically efficient since they would only be efficient if product(s) demand was perfectly inelastic.

3.35 In effect, DSAC is a cost method created for purposes of allowing BT flexibility to set prices above FAC but not as high as SAC. However, DSAC does not bear any relation to economic efficiency considerations. DSAC might by chance allow the appropriate level of flexibility and so be an appropriate test. However, it seems obvious to us that there is no economic logic that makes DSAC appropriate as the ultimate benchmark as to whether charges are cost-orientated or not. It is worth noting that for a group of products the prices allowed using DSAC might be higher than those allowed under a group SAC test.

3.36 In particular, there is no evidence or justification for Ofcom's claim that DSAC sets the '*appropriate'* level of price flexibility (§11.41). If Ofcom maintains this assertion it should provide some evidence and reasoning to support it.

3.1.3 Incentive to minimise costs

3.37 Economic efficiency is enhanced if there are incentives to minimise costs (productive efficiency). Ofcom say that DSAC creates better cost minimisation incentives than FAC:

> *DSAC provides BT with the incentives and flexibility to reduce costs (§9.19.2)*
>
> *Imposing FAC as the maximum level of any charge would also risk imposing 'rate of return‖ regulation'. If no individual charge could earn a rate of return above the firm's Weighted Average Cost of Capital ('WACC'), then the maximum rate of return that BT could earn in the market as a whole would also be the firm's WACC. This provides BT with no incentive or ability to recover common costs in an efficient manner across the full range of services that share them. <u>Nor does it provide BT with an incentive to reduce costs, as it would not benefit from any cost savings that it made since these would immediately be passed on to BT's consumers</u>.*

3.38 We consider this assertion to be incorrect.

3.39 Cost minimisation incentives arise where reductions in costs result in increased profits for the firm. In the case of a charge control where the prices are (for a period) fixed irrespective of actual costs then all reductions in costs that a firm achieves flow through to additional profits[iv]. Thus charge controls provide strong (or 'high powered') cost minimisation incentives.

3.40 However, in the case of cost orientation the cost measure Ofcom uses to test prices is BT's <u>actual</u> DSAC costs. Therefore, Ofcom's approach will result in no cost minimisation incentive since if BT reduces its actual DSAC costs the cost reduction will be fully passed through in reduced prices. Similarly, if Ofcom used BT's actual FAC to assess cost orientation compliance then there would also be no cost minimisation incentives. This is true irrespective of whether actual FAC or actual DSAC is used.

3.41 It follows that there is no additional cost minimisation benefit that results from using actual DSAC rather than actual FAC. In other words, allowing a greater degree of price flexibility (i.e. allowing prices to be higher) does not create greater cost minimisation incentives. Therefore, Ofcom is incorrect when it asserts that DSAC provides better cost minimisation incentives that (say) FAC.

3.42 If Ofcom consider that using actual FAC to judge cost orientation would be tantamount to 'rate of return' regulation then so would using DSAC be a form of rate of return regulation. The only difference is that if FAC is used the allowed return is 11.4% whereas with DSAC the allowed return is 41%. Thus, any criticism of FAC equally or more applies to DSAC.

3.1.4 Efficient entry and investment signals

3.43 Economic efficiency is improved by sending efficient entry and investment signals to BT and to actual or potential entrants in the market. Entry/investment will be most efficient if prices are set at the 'efficient forward looking' costs. If prices are set above efficient forward looking costs it will induce over-production / excessive expansion by BT / other existing providers and encourage inefficient entry (inducing and resulting in allocative inefficiency and productive inefficiency).

3.44 In particular, if price differences for different build/ buy entry options do not reflect the incremental cost differences (i.e. efficient forward looking cost differences) then it will induce distorted choices. For example, if the price difference for MPF compared to WLR/IPStream reflects more than the incremental cost differences (because, for instance, there are different absolute mark-ups for common costs) then the choice will be distorted.

3.45 Therefore, in this context efficient forward looking means:

3.45.1 'efficient' means the costs of a best practice operator (rather than the actual costs of BT)

3.45.2 'forward looking' means costs that:

3.45.2.1 are incremental and incurred as a result of production of the service (normally in the long run)

3.45.2.2 exclude fixed and common costs and sunk costs[14] (in a purist sense if only efficient entry is concerned)

3.46 Notably both the Access Directive and the NCC Guidelines emphasise that it is appropriate to use an efficient operator's costs (rather than actual costs) in assessing cost orientation.

> *Where an operator has an obligation regarding the cost orientation of its prices …. For the purpose of calculating the cost of efficient provision of services, national regulatory authorities may use cost accounting*[15]
>
> *Ceilings should reflect the costs of an efficient operator because they are intended to prevent excessively high or exploitative pricing*[16]

3.47 Efficient operators' costs will be equal to or (more likely) below BT's actual costs – in the recent LLU/WLR charge control Ofcom considered that efficient costs were about 9% below BT's actual costs[17].

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[14] In respect of efficient investment incentives it is useful to recognise that a 'purist' economic approach would suggest that sunk costs should not be recoverable (suggesting that prices below efficient FAC are appropriate). Ofcom's approach allows the recovery of certain sunk costs (such as duct) to avoid expropriation and so disincentivise future investments in assets that might be subsequently considered as sunk. We agree with this approach in this case. However, this point reinforces the point that prices as high as DSAC create inefficient investment incentives.

[15] Access Directive Art. 13(3)

[16] Guidelines on the Operation of the Network Charge Controls B.8

3.48 In the case of WES/BES, prices far above efficient forward looking costs is likely to distort build/buy signals since there are substitutional products (e.g. TISBO) whose prices are based on FAC (since they are regulated by means of charge controls). In this case, there will be inefficient investment in use of the lower priced product.

3.49 Therefore, for the reasons outlined above investment/entry will be most efficient if prices are set below BT's actual FAC. Efficient forward looking costs will be less than FAC since they (a) exclude fixed and common costs, (b) exclude sunk costs and (c) are based on efficient costs (which are less than actual costs).

3.1.5 Effective competition in downstream markets

3.50 Competition in downstream markets will be least distorted and most effective if prices are set at efficient forward looking costs and so below BT's actual FAC. Prices above efficient forward looking costs will mean BT's downstream rivals experience higher costs than BT's own (vertically integrated) retail activities[v] thus creating a margin squeeze and resulting in distorted and weakened competition and thus less innovation, less investment, less choice and higher downstream costs. A margin squeeze is something that the Access Directive and Act made explicitly clear should be avoided[18].

3.51 Therefore, to ensure that downstream competition is most effective and efficient, prices should be set at efficient forward looking cost which is below actual FAC (as explained §3.49 above)[vi].

3.1.6 Welfare enhancement / allocative efficiency

3.52 Efficiency will be enhanced if overall prices are set to recover total costs (no more and no less). If prices/revenue are above overall cost then efficient demand will be suppressed. This 'no over-recovery' principle is at the heart of price regulation. For example, in respect to LLU/WLR charges[19]:

> *Our specific policy objectives in proposing the charge controls for LLU and WLR services are: … to ensure that the delivery of the regulated services is sustainable, in that the prevailing prices provide BT with the opportunity to recover all of its relevant costs (where efficiently incurred), including its cost of capital.*

3.53 The 'no over-recovery' principle also appears to be well accepted by Ofcom and the CAT in the context of a cost orientation obligation. For example:

> Ofcom PPC Determination (§7.118): *The existence of significant common costs requires BT to also demonstrate that those common costs are/were not over-recovered from all the services that share them.*

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[17] In the recent LLU/WLR charge control BT was estimated to be able to reduce costs by 5% (gross) per year for three years. Assuming a frontier movement of 2% a year this implies that BT's actual costs were 9% (= [5% - 2%] x 3 years) above the efficient level at the start of the charge control. We know of no situation where Ofcom considered that BT was efficient

[18] Access Directive Art 13(1). Communications Act s88(3)(b)

[19] 2012 LLU/WLR Charge Control §2.26

Ofcom PPC Determination (§7.121): *"… the aim of any such combinatorial analysis is to <u>ensure that common costs are not over-recovered</u>."*

CAT PPC Judgement (§256): *Had BT demonstrated an absence of over-recovery of common costs through a series of combinatorial tests, then this would have been an appropriate way of demonstrating an appropriate mark-up for the recovery of common costs.*

3.54 It is self-evident, we think, that over-recovery of costs will not 'confer the greatest benefits on consumers' as is the intent of a cost orientation condition.

3.55 Within this overall rule on overall recovery, welfare and allocative efficiency is affected by how common cost is recovered across different individual products.

3.56 One approach to allocate common costs between individual products is to allocate/recover costs 'uniformly' or 'neutrally' as is done in FAC or LRIC+EMPU methods. However, consumption can be increased and welfare can be enhanced (and surpluses maximised) by using a Ramsey-based pricing approach whereby more common cost is allocated to / recovered from products with relatively inelastic demand and less from products with relatively elastic demand[20]. Thus Ramsey-based prices on relatively inelastic products will be above FAC (higher mark-up) and on relatively elastic products below FAC (lower mark-up). In the case where product (super-)elasticities are the same then the optimal prices would be where common costs are recovered uniformly i.e. FAC or LRIC+EPMU.

3.57 It is absolutely critical and fundamental to recognise that there are two elements to achieving allocative efficiency under Ramsey-based pricing:

3.57.1 Higher mark-ups on inelastic products

3.57.2 **<u>and</u>**, lower mark-ups on more elastic products (ensuring cost-recovery)

3.58 Ramsey pricing is what Ofcom appears to mean when it says that "*DSAC provides BT with the […] flexibility to efficiently recover common costs*" (§9.19.2) – see also §9.55, §11.39. In other words, Ofcom understandably wishes to allow BT some flexibility to set prices above/below FAC in order to improve allocatively efficiency. We agree that this is a valid objective (if suitably constrained and enforced).

3.59 Below we discuss whether Ofcom's DSAC ceiling only approach is appropriate in the context of achieving allocative efficiency:

3.59.1 Is DSAC an appropriate level of flexibility to allow Ramsey pricing? (Section 3.1.7)

3.59.2 Has the 'no overall over-recovery' objective been met ? (Section 3.1.8)

3.59.3 Lastly, has BT provided (as it is required to do) the evidence to demonstrate its prices are appropriate ? (Section 3.1.9)

[20] Ramsey pricing approach minimises the 'deadweight loss' (DWL) or surplus losses that result from prices being set above marginal cost / LRIC. Prices based on Ramsey pricing are sometimes referred to as 'second-best' prices. First best prices would be to set prices based on incremental/marginal costs which would maximise welfare. However, this would prevent recovery of common costs. A simple form of Ramsey pricing is that mark-up should be in proportion to the inverse of the elasticity

3.1.7 Is DSAC an appropriate level of flexibility ?

3.60 As described above Ramsey pricing can improve welfare through recovering more common cost from inelastic products. The question in practice is whether in this case prices as far above FAC as DSAC are justified by the price elasticities. Ofcom claim that DSAC is an 'appropriate' level of flexibility (though it provides no reasoning or evidence to support this claim).

3.61 To address the question of whether Ramsey pricing justifies WES/BES prices as high as DSAC it is firstly necessary to identify what elasticities are relevant.

3.62 If we take the case of BES products whose key common cost that is shared with other products is backhaul duct. Backhaul duct supports the delivery of broadband, calls and trunk leased lines. The efficient recovery of common backhaul duct cost depends on the elasticity of the end-user demand for the different retail products that duct supports. The elasticity of wholesale demand is not relevant *per se*[vii].

3.63 For instance, if (say) retail calls are relatively more inelastic then more common costs should be allocated to them. Therefore, the appropriate allocation of backhaul duct common costs to BES depends on the retail products that BES supports. If BES supports proportionally more of the more inelastic services then proportionally more common duct cost should be recovered from BES (if allocative efficiency were the only consideration).

3.64 We can then consider what the relevant elasticity evidence is. Again, using the example of BES:

3.64.1 BES is used by LLU operators principally to provide mostly residential retail broadband and retail calls[21] (and to a lesser degree the trunk component retail Ethernet circuits)

3.64.2 Backhaul duct is also used to produce a number of other retail products most particularly:

3.64.2.1 residential and business retail calls[22]

3.64.2.2 residential and business retail broadband services[23]

3.64.2.3 trunk portion of retail leased lines (TI) and Ethernet circuits (AI)

3.65 Given the relevant elasticities two key conclusions can be drawn:

3.65.1 First, common backhaul duct cost is used for retail activities that are similar to the retail activities that BES is used for e.g. calls, broadband, trunk Ethernet. Therefore, there is unlikely to be much difference in the relevant elasticities that would justify a higher allocation of duct cost to BES.

3.65.2 Second, BES[24] tend to be used less for business use (which tends to be more inelastic that residential use) and less for retail leased lines/Ethernet circuits

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[21] Lines (e.g. the equivalent of WLR or retail lines) do not depend on backhaul duct to any large degree
[22] either provided by BT Retail or by rivals who purchase wholesale NCC services from BT
[23] either provided by BT Retail or by rivals who purchase WBA services from BT

(which tend to be more inelastic). This would suggest that, if anything, less backhaul duct cost should be recovered from BES.

3.66 Thus the evidence indicates (certainly for BES) that if anything a lower mark-up (and so prices below FAC) would be justified by Ramsey-based pricing.

3.67 If elasticities for WES/BES were higher and so it was appropriate to mark-up certain WES/BES products a further question is by how much is it appropriate to mark-up. The optimal level of mark-up depends on (as well as the relative elasticities) other factors such as proportion of costs that are common, shape of demand function and volume of service[25]. We have developed a simple model to estimate optimal Ramsey-based prices. This can provide an indication of the likely level of prices above FAC that would be consistent with Ramsey-based prices. TalkTalk are very happy to provide this model to Ofcom.

3.68 For an individual product (say BES1000 rental) a price set at DSAC (i.e. about twice FAC) would only be efficient if BES1000 was used to support retail services that were about <u>three times more inelastic</u> than other relevant retail services[viii]. This is highly implausible given that (as explained above) BES is used to serve similar products at the retail level as the other uses of common backhaul duct cost.

3.69 This same analysis can be conducted on a group of products such as (say) external WES/BES in aggregate. In this case, prices set at DSAC would only be efficient if external WES/BES was used to support retail services that were <u>more than three times more inelastic</u> than other relevant retail services[ix] than other uses of the common costs that it shares. This is even more implausible given that WES/BES is used to serve almost identical products at the retail level as the other uses of common access and backhaul duct cost.

3.70 Thus we consider that in this case allowing prices as high as actual DSAC on any product is not necessary to allow efficient Ramsey pricing. A much lower ceiling than DSAC is amply sufficient to give BT the required degree of pricing flexibility to gain the economic efficiency benefits of Ramsey pricing[26].

3.71 Ofcom has claimed that DSAC allows the ‘appropriate’ level of flexibility. There is no evidence to support this claim. In the case of WES/BES the evidence supports a far more limited degree of flexibility.

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[24] The LLU operators who used BES (TalkTalk, Sky, Fiscal, AOL, Orange) were all focussed on (and had higher market share in) the residential market

[25] A higher mark-up (or price above FAC) on a product would be optimal if (a) the product is more inelastic and a small proportion of total demand and (b) if a high proportion of costs are common

[26] We also note that having different mark-ups is likely to lead to distortions where there are substitute products since customers would migrate to the lower mark-up product. This would distort build/buy decisions. It would also in the case that prices were set to recover FAC lead to under-recovery since demand would switch to the lower mark-up product.

3.1.8 Has the 'no overall over-recovery' objective been met?

3.72 For prices to be efficient not only do individual product prices need to be efficient but in addition prices in aggregate need to be efficient[x]. In particular prices need to be set so that total efficient common costs are not overall over-recovered[27]. This means that higher than FAC prices on some products must be offset by prices lower than FAC on other products.

3.73 Thus it is necessary to check whether higher than FAC prices on external WES/BES products are offset by lower that FAC prices (i.e. under-recovery) on other products that share the same common costs. In our view, the other relevant services in which we can look for common cost under-recovery need not include:

3.73.1 Charge controlled products should not be included since their prices are set at (projected) FAC and so there should not be any under-recovery (i.e. prices below FAC). If there were under-recovery[28] i.e. prices below FAC (due to say BT's actual costs being higher than estimated when setting prices) then allowing BT to 'pass on' this under-recovery to WES/BES products would undermine the central purpose of the charge control which is for BT to fully bear the consequences of its performance to provide strong cost minimisation incentives[29].

3.73.2 Services where BT does not have SMP (i.e. competitive services) should not be included. This is for several reasons:

3.73.2.1 Many of BT's non-regulated products share little of the key common costs (e.g. duct) with WES/BES e.g. BT's international and BT's IT services activities. Clearly there can be no under-recovery of the relevant common costs from these products

3.73.2.2 If over-recovery in WES/BES were allowed to be offset by under-recovery in non-regulated services (say retail broadband) it would effectively give BT a 'back door' method to shift a large proportion of common costs from non-regulated services onto regulated products. This would defeat the purpose of price regulation which is to avoid excessive prices on regulated prices and BT prevent 'cross-subsidising' competitive markets from regulated markets.

3.74 Thus in relation to offsetting an over-recovery in WES/BES an under-recovery needs to be shown in regulated products with cost orientation obligations where no charge control applied. The key markets/products which meet these criteria of having cost

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[27] Given BT's costs are higher than efficient costs then arguably the total recovery should be less than BT's actual costs

[28] The RFS may show under-recovery for two other reasons neither of which would be relevant. First is that the RFS costs are greater than Ofcom's view of the appropriate costs since BT prepares the RFS on the basis of its (not Ofcom's) view of (say) valuation (e.g. excluding RAV adjustment) and allocations. Second, there may be an intentional under-recovery where due to the nature of the glidepath prices are intentionally set below cost

[29] Allowing this would also be asymmetric since there would be no equivalent mechanism to share 'over-recovery' i.e. prices above costs

orientation obligations but no charge controls in the relevant period were: ISDN, TISBO trunk/support and other AISBO.

3.75 The table below shows average prices as a % of FAC for these markets/products. It is highly revealing. There were in fact no offsetting prices below FAC for these other products. In fact the very opposite these other products prices were well above FAC – price averaged 171% of FAC, ROCE was 40%. In total the revenue above FAC for these products across the three years was over £450 million.

Prices/returns on cost orientated products[xi]

Product group	Revenue above FAC	Price % FAC	ROCE
ISDN	£208m	166%	44%
TISBO trunk, ECC, support	£149m	244%	65%
Other AISBO	£95m	144%	26%
Total	**£453m**	**171%**	**40%**

3.76 This data (i.e. the higher than FAC prices on other relevant products) would suggest that higher than FAC prices for WES/BES products cannot be justified since there was no offsetting under-recovery / lower than FAC prices. Arguably since there were higher than FAC prices on these other products then in resolving this dispute WES/BES product prices should (in aggregate) be set at less than FAC to offset the higher mark-up on other services.

3.1.9 Absence of evidence supporting higher mark-up for WES/BES

3.77 As we have explained above for prices set at DSAC to be efficient and so compliant with cost orientation obligations requires two conditions to be met.

3.77.1 First, that retail products that WES/BES supports were substantially more inelastic than other retail products that share common costs with WES/BES (e.g. duct).

3.77.2 Second, that there were lower mark-ups (i.e. below FAC pricing) for other relevant regulated products to offset the prices above FAC on WES/BES.

3.78 The available evidence indicates that neither condition is met: the retail products that BES products serve are more elastic (or of similar elasticity) and there was over-recovery on other relevant products.

3.79 It is of course open to BT to provide evidence that justifies its prices. In fact, this is not an option – BT is obliged to demonstrate that its prices are comply with the cost orientation condition by being economically efficient and conferring the greatest benefits on consumers[30]. We make a number of comments regarding BT's obligation to furnish evidence to support its prices:

3.80 First, the obligation on BT to furnish detailed evidence is reinforced by Ofcom's approach in respect of BT's of demand unpredictability and risk where Ofcom has required BT to furnish it with detailed evidence to support its claims (see §§9.77 and 13.25).

3.81 Second, it may be claimed by BT and/or Ofcom that obtaining reliable and relevant price elasticity data and/or computing Ramsey efficient prices is difficult. If this is the case the question arises of what the default position should be absent evidence to demonstrate that differential mark-ups are justified. We contend that the only legitimate default position would be to assume that elasticities are the same or similar (in which case the mark-ups should be the same and the prices should be set at FAC). Allowing BT substantial price flexibility (for the purpose of Ramsey-based pricing) without any elasticity evidence that would justify that Ramsey-based prices are much higher than FAC would allow BT to raise the prices of products without any justification. It would also be incompatible with Ofcom's duties and HH3.1. The fact that data is not available cannot mean that BT is relieved of its obligation to make sure its prices are based on efficient costs.

3.82 Third, BT has had ample opportunity to provide the necessary data yet has not done so despite the fact that this is a positive obligation on BT under Condition HH3.1. As far as we are aware BT has not provided any of the necessary evidence on elasticities or under-recovery elsewhere to justify its actual prices (or even prices as high as DSAC). Instead it has chosen to present spurious data such as international benchmarks and irrelevant rhetoric (such as only testing at aggregated level). It is arguable that BT has breached its regulatory obligations by not providing the necessary evidence.

3.83 Fourth, it is notable that Ofcom argue (§9.56) that BT need to be allowed the flexibility to adjust prices since they have the best understanding of demand (i.e. elasticities) – and no doubt BT support this contention. If it were true that BT understood demand to set efficient Ramsey prices then it must provide the data to justify the prices (as we know it has not). If BT does not have the demand data[31]

[30] Condition HH3.1: Unless Ofcom directs otherwise from time to time, the Dominant Provider shall secure, and shall be able to <u>demonstrate</u> to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition HH1 is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed.
See also Interconnection Directive: Charges for interconnection shall follow the principles of transparency and cost orientation. The <u>burden of proof that charges are derived from actual costs including a reasonable rate of return on investment shall lie with the organization providing interconnection to its facilities</u>. National regulatory authorities may request an organisation to provide full justification for its interconnection charges, and where appropriate shall require charges to be adjusted

[31] Regarding BT's access to the relevant elasticity data we also note that: (a) the relevant price elasticities are those at the retail level and it is unlikely that BT's business units that set prices for the

then there could not have been (and there is not) any justification for giving BT pricing flexibility in the first place.

3.84 In summary, BT have a clear obligation to justify that their prices were cost orientated. This requires:

3.84.1 Evidence on relative elasticities and particularly that retail products that use WES/BES are substantially more inelastic. BT have not provided such justification. In the absence of data on relative elasticities the sensible default assumption is that there is no difference in elasticities.

3.84.2 evidence that there has been no over-recovery elsewhere which appears not to be the case

3.85 Individually or together these both indicate that a ceiling as high as DSAC for WES/BES products is not justified.

3.2 Appropriate price levels and overcharge

3.86 The analysis above points to two broad approaches to assessing what compliant prices would be and so how to derive the overcharge.

3.87 The <u>first method ('product test'</u>) would be to consider what are economically efficient prices for individual and/or groups of WES/BES products (ignoring at this stage whether there was any offsetting under-recovery on other products e.g. ISDN). The key economic considerations are:

3.87.1 Competition will be most effective if prices are set at efficient forward looking costs or efficient FAC (both of which below actual FAC).

3.87.2 Entry/investment will be most efficient if prices are set at efficient forward looking costs or efficient FAC (both of which below actual FAC)

3.87.3 Allocative efficiency will be maximised by prices above FAC if WES/BES products supported retail services that had relatively inelastic demand. However, the retail products that WES/BES supports are unlikely to be relatively inelastic and certainly not significantly more inelastic

3.87.4 Cost minimisation incentives are neutral as between setting prices at FAC or above FAC. Allowing BT flexibility to set prices above actual FAC (say at actual DSAC) does not improve or increase cost minimisation incentives.

3.88 Where to set the ceiling depends on economic priorities.

3.89 For example, if allocative efficiencies were the only concern and it were shown that certain individual products were (say) 100% more inelastic[32], then the ceiling should (on individual products) be set at FAC + 50%. This would allow BT the necessary flexibility to set Ramsey prices. If it were shown that as a group WES/BES products

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products (Openreach, BT Wholesale) have access to retail elasticity data; and (b) BT has not indicated it used elasticity data in making its decisions

[32] Elasticity individual product $\varepsilon = -0.13$ Elasticity other products $\varepsilon = -0.25$

were on average 50% more inelastic[33], then the ceiling on the WES/BES group be set at FAC + 25%.

3.90 In the alternative if effective competition and/or efficient entry/investment were the only concern then the ceiling would be set at, or close to actual FAC.

3.91 In considering the weight to give to these different considerations it is relevant to note that the economic benefit (i.e. increased surpluses) that derives from Ramsey pricing is fairly small. For example, in the WES/BES product group example above (WES/BES products were on average 50% more inelastic) the reduction in deadweight losses resulting from Ramsey pricing (rather than FAC) was just 0.3% of total costs. In other words, if setting prices at Ramsey pricing levels caused just a 0.3% increase in costs due to say less effective competition and inefficient entry / investment market entry signals then it would outweigh any Ramsey pricing benefits.

3.92 Given the importance of competition and efficient investment to Ofcom but allowing BT a huge 'benefit of the doubt' on elasticities, we think that a reasonable (though very generous to BT) set of ceilings would be:

3.92.1 For individual products: ceiling at FAC+30% ('individual product test')

3.92.2 For a group of products such as WES/BES: ceiling between FAC+10% ('group of products test')

3.93 These ceilings allow significant and sufficient flexibility to recover common costs efficiently both within WES/BES and between WES/BES and other services which share common costs whilst also reflecting other economic considerations which indicate that prices should be at / below actual FAC.

3.94 Allowing prices at an individual and a group level of FAC+95% as Ofcom is suggesting is unreasonable and without an evidential basis or justification.

3.95 The second method ('overall recovery test') is to verify whether any over-recovery on WES/BES was offset by under-recovery elsewhere. As we explained above there was no under-recovery on other relevant products and therefore there was no justification for above FAC pricing on WES/BES. This effectively sets a cap on WES/BES products in aggregate at FAC.

3.96 Using these different tests we can calculate the allowed revenue and so the overcharge. The table below shows the overcharge using different assumptions.

Calculation of overcharge on WES/BES (excl 2009/10)

Test	Overcharge
Ofcom test: each product ceiling DSAC	£116m
Individual product test: each product ceiling FAC + 30%	£174m
Group product test: WES/BES aggregate ceiling FAC + 10%	£192m
Overall recovery test: WES/BES capped at FAC	£205m

[33] Elasticity individual product ε = –0.17 Elasticity other products ε = –0.25

3.97 Importantly, these tests are cumulative: the prices/revenue should pass:

3.97.1 individual product tests (for each/every WES/BES service).

3.97.2 <u>and</u> a product group test (for external WES/BES in aggregate)

3.97.3 <u>and</u> an overall recovery test

3.98 Put another way, the allowed price/revenue is the minimum price/revenue of the different tests. Accordingly, we consider that reasonable assessment of the overcharge is £205m[34] the maximum of three tests (excluding 2009/10).

3.99 BT has argued that there should only be a test at an aggregated level i.e. not at an individual product level. The economic reasons for having an individual product level check are outlined above. We address some of the other reasons in Annex A.

3.3 Other considerations

3.100 In this section we discuss other considerations that Ofcom/BT have suggested are or may be relevant to the approach to assessing compliance with cost orientation obligations. The sections are:

3.100.1 Do expectation and/or regulatory certainty concerns affect the approach to assessing compliance ?

3.100.2 How does cost predictability affect the approach ?

3.100.3 Do practicality considerations support the use of DSAC ?

3.100.4 What is the allowed appropriate WACC for WES/BES products?

3.100.5 Role of SAC/combinatorial tests

3.3.1 Expectation / regulatory certainty

3.101 It appears that Ofcom considers that its approach of a DSAC ceiling only on individual products is required by virtue of regulatory certainty or even expectation.

> *"[moving away from DSAC would be] inconsistent with our previously stated position and regulatory practice." (§9.61)*
>
> *'use of DSAC was recognised by BT as the approach that Ofcom would adopt for analysing whether charges were unreasonable' (§9.19.3).*
>
> *'[DSAC is] consistent with the principle of regulatory certainty' (§9.50)*

[34] In the case that the overcharge (i.e. maximum of three tests) is not the individual product test then it would become necessary to allocate the overcharge between products. This could be done in proportion to the individual product overcharge versus FAC or in proportion to the individual product overcharge versus DSAC

3.102 If this is Ofcom's contention, we consider that Ofcom is incorrect. We tackle the questions of BT's expectation and regulatory precedent together below since they touch on similar issues.

3.103 First, it has been clear since the NCC Guidelines in 1997 that DSAC is not the only test or the 'be all and end all'. The description of DSAC as a 'first order test' makes this plain. This point has been reinforced and made explicit on many occasions:

3.103.1 in the NCC Guidelines Ofcom said: "*However, there may be circumstances in which charges set outside the band of floors and ceilings are not abusive, or charges set within the band are abusive*." [35]

3.103.2 These other considerations would take into account "*the effect or likely effect of the charge on competition and on consumers*" [36].

3.103.3 In the PPC Determination (§5.37) Ofcom said: "*The Guidelines make clear that this test should not be applied mechanistically to individual services and that other factors need to be taken into consideration before it can be concluded that charges are unreasonable or otherwise anti-competitive*."

3.104 Therefore BT should have reasonably expected that Ofcom would take into account other factors and in particular economic efficiency considerations in assessing whether its prices were compliant. Most particularly, BT could not have reasonably expected that Ofcom would have taken an approach to cost orientation that would have allowed BT to substantially over-recover costs across its regulated product set (see §3.75). Therefore, it cannot be said that Ofcom's antecedent position/practice indicates or requires only the use of a DSAC ceiling test.

3.105 It is notable that BT itself seemed to recognise that DSAC represented the highest possible ceiling that could be allowed – in other words, BT understood that the allowed price ceiling might be set below DSAC. For example:

Complex combinatorial tests are avoided through the use of DSACs, which reduce pricing freedom by lowering the maximum price that can be charged. This results in ceilings for individual components that are below their actual SACs.[37]

To avoid complex combinatorial tests, DSACs are calculated by attributing fixed common costs shared between the Core and other increments to individual components. This results in ceilings for individual components that are below their actual SACs. [38]

3.106 Second, regarding whether previous decisions bind Ofcom's approach in this dispute it is clear that this dispute should be considered and resolved on its merits. Ofcom cannot fetter its approach to resolving this dispute by decisions it makes elsewhere regarding cost orientation.

[35] Guidelines on the Operation of the Network Charge Controls B.2
[36] Guidelines on the Operation of the Network Charge Controls 3.1
[37] BT Regulatory financial Statements, 2008 Primary Accounting Documents s3.5.3
[38] BT Regulatory financial Statements, 2010 Primary Accounting Documents s5.3.5. Interesting how BT have removed the word 'maximum'

3.107 In any case, Ofcom has been clear that the approach to assessing compliance is case sensitive. For example (PPC Determination §5.38):

> *The specific indicators or issues may be dependent on the precise details of the case under consideration.*

3.108 In the PPC Dispute Appeal the CAT was clear that in other disputes Ofcom may take an alternative approach to assessing cost orientation (from §287*ff*):

> *… Of course, OFCOM would, no doubt, be open to considering fresh alternatives to DSAC, were such to emerge. This was put to Mr Myers (Transcript Day 3, page 40):*
>
> *Q (Mr Read):...Is it fair to say, Mr Myers, that DSAC is really, you are the primary person responsible for that test?*
>
> *A (Mr Myers): No, that wouldn't be correct. Clearly there were other people who at the time were significantly more senior to me in Oftel, who also participated in and guided that process of deciding that DSAC was a sensible first order test.*
>
> *Q: But in any event, you are one of the key people who has been involved in this development over the years.*
>
> *A: Yes. Yes, that's true.*
>
> *Q: So, in a sense, this is a bit of your "baby", is it not? DSAC is the test that you have developed and implemented over the years. Is that right?*
>
> *A: Well, yes, I contributed to the development of DSAC as the first order test.*
>
> *Q: And so the last thing you would like to see is that test being knocked down in any way.*
>
> *A: No, that's not true. If there were sound reasons to suggest that things had moved on, that there was a better way of assessing cost orientation, a better way of judging those questions, then I would be perfectly open to that and don't hang on to things in the past just because I was involved in them at the time."*
>
> *We accept this evidence. The fact is that no satisfactory alternative to DSAC was demonstrated by BT ….*

3.109 Third, and in any event, other cases where Ofcom has resolved disputes and/or made statements regarding cost orientation (interconnection products in 1997 and 2001; ISDN in 2004; PPC in 2009) either do not support the use of DSAC or are of limited/no relevance to this case of WES/BES.

3.110 In the case of interconnection products (where the DSAC test on each/every product was originally conceived) a concurrent charge control basket applied (the NCC). This basket constrained overall cost-recovery and therefore the cost orientation obligation only needed to provide a constraint on the pricing of individual product(s) – it was not necessary for cost orientation tests to constrain overall-recovery.

3.111 This was explained in the PPC Determination §§A11.37, A11.38):

> *For services within charge control baskets, however, BT's ability to set charges close to the ceiling will be constrained by the requirement for it to comply with the charge control. This is because the charge control is designed to regulate charges relative to the FAC or the incremental costs of providing the services plus a proportion (but not all) of the common costs shared by the services. Therefore, setting one charge within a basket near the ceiling*

will mean that other charges in the basket will need to be set nearer the floor to meet the requirements of the control.

Cost orientation obligations were therefore imposed in conjunction with basket-level charge controls to provide a complementary (but independent) constraint on BT's ability to flex individual prices in order to recover common costs in a way that could be considered inappropriate or, indeed, anti-competitive.

3.112 In the case of WES/BES there was no charge control basket and so the cost orientation obligation needs to also provide a constraint on overall recovery. Thus the approach to cost orientation for interconnection products cannot act as a precedent as to what appropriate cost orientation tests should be.

3.113 The PPC Dispute (in 2009) and subsequent appeal is of limited relevance to the WES/BES case for a number of reasons. In that case, there was only a single product that was considered non-cost orientated (2Mbps trunk) and FAC was rejected as a cost orientation test for this individual product. This is different in a number of respects to the WES/BES case:

3.113.1 The CAT did not consider the merits of using ceilings lower than DSAC on each/every individual products since no lower ceilings were proposed. The CAT did though reject the use of a FAC ceiling on each/every product – however, this is not what TalkTalk is proposing in this case. Instead the appeal concerned whether BT had advanced a satisfactory higher alternative to DSAC and the CAT concluded that they had not: "*The fact is that no satisfactory alternative to DSAC was demonstrated by BT …*"

3.113.2 The CAT did not consider what would be an appropriate ceiling on a group of products (most obviously since only one product was at issue). In any case, had the CAT considered a group test it may have found BT compliant since other PPC products had prices below DSAC and/or below FAC and across PPC products (which were purchased in conjunction with 2Mbps trunk) the return averaged 12.2%[39] (versus 68% in this case)

3.113.3 The CAT did not consider (since it was not asked to) whether there had been under-recovery on other products that share common costs with 2Mbps trunk

3.114 In any event, the PPC Determination was made in October 2009 and so could have had no impact in setting BT's expectations when BT set prices in the period April 2006 to July 2009. For this reason we do not consider that the PPC Dispute can play any role in setting precedent or be relevant to regulatory certainty.

3.115 In the ISDN dispute (in 2004) Ofcom determined the allowable cost orientated ISDN2 price on the basis of LRIC+EPMU (which is similar to FAC) and said:[40]

Ofcom has considered what is meant by an "appropriate mark up" and an "appropriate return on capital employed". In the case of WLR ISDN2, BT's SMP in the relevant market is

[39] see Table 7.3 of Ofcom PPC Dispute Determination

[40] Resolution of dispute between Energis and BT about an alleged overcharge for WLR ISDN2 for the period 28 November 2003 to 1 October 2004 §46

entrenched and the product is not a new one. This means that it is reasonable for "appropriate" to be interpreted as an equal proportionate mark-up for common costs, consistent with other services in which BT has persistent SMP and Ofcom has determined charges, and an allowed rate of return equal to the cost of capital.

3.116 In summary and on the basis of proper analysis, previous practice certainly does not suggest that a DSAC test alone is the appropriate test to apply in the case of WES/BES:

3.116.1 In the case of interconnection products, there was a basket charge control which constrained overall cost-recovery and therefore it was not necessary for cost orientation tests to set constraints on overall-recovery. Thus the approach to cost orientation for interconnection products cannot act as a precedent as to what appropriate cost orientation tests should be for WES/BES

3.116.2 The PPC dispute was significantly different and anyway occurred too late to have set BT's expectations (unless BT was able to see into the future!)

3.116.3 The ISDN dispute actually set LRIC+EPMU as the ceiling

3.117 Fourth, and in any case, it was always clear that BT had to provide evidence that its prices were efficient. Given this it would make no sense to suggest that a DSAC ceiling alone was somehow set in stone as an approach to assessing compliance.

3.118 Taking these points together, BT's reasonable expectation should have been that

3.118.1 the ceiling on each product was below DSAC

3.118.2 how much below DSAC the ceiling would be set would depend on other considerations including economic efficiency considerations.

3.118.3 BT would have to provide evidence to justify its prices

3.119 In particular, even if BT were a little unsure of the exact level of ceilings on individual or groups of products, BT could not have reasonably expected that they would have been permitted to over-recover common costs since the purpose of the cost orientation obligation clearly is to 'promote economic efficiency' and 'confer the maximum benefits on consumers'.

3.120 It is important to note here that using other tests apart from the DSAC ceiling on each/every product is not placing an impossible burden on BT of trying to guess what Ofcom's approach to testing compliance might be. Instead it simply requires BT to mitigate risk by avoiding wildly uneven mark-ups and ensuring that it does not over-recover its costs overall. One approach BT could have taken was to price all products at FAC – if it had done this it would have recovered its costs and been compliant. That BT chose to take an approach that exposed it to compliance risk can be no defence.

3.121 Therefore, we do not believe that BT can rely on any legitimate expectation that DSAC at an individual product level would be used as the only test to assess compliance with its cost orientation obligations. Furthermore, using different tests is not incompatible with previous practice and so is not incompatible with regulatory certainty.

3.3.2 Predictability of unit costs

3.122 BT has argued that the assessment of whether BT overcharged should reflect their view that AISBO products were 'nascent'[41] and so difficult to forecast (though they are vague as to why nascency justifies a different compliance check or what different compliance check should be applied). (§§8.26, 9.37). Ofcom also indicate that its decision on overcharging might reflect potential difficulties in forecasting costs:

> *In the PPC Final Determinations we therefore concluded that, for the purposes of resolving the PPC Disputes, overcharging had occurred where charges had been persistently above DSAC for the majority of the period (i.e. for at least three out of the five financial years to which the PPC Disputes related). We argued that charges above DSAC for this length of its charges appropriately. However, where charges exceeded DSAC in fewer than three financial years, we argued that consideration of the specific circumstances is warranted. (§9.33)*
>
> *If BT was able to demonstrate that, despite reasonable endeavours, its charges exceeded DSAC as a consequence of genuine difficulties in forecasting unit costs, we may consider that charges above DSAC were nonetheless cost orientated.* (§9.38)

3.123 We accept that there might be a limited degree of difficulty predicting costs highly accurately though we make the following observations:

3.124 First, it is clearly relevant that BT has been able to produce audited RFS in the years concerned to an increasing level of granularity for WES/BES. It should also be noted that though the RFS are produced on an annual basis BT could have produced granular cost estimates for WES/BES that were both regular (e.g. monthly or quarterly) and timely (i.e. 1 month after period end)[42]. It would simply not be possible to run a business of BT's scale without a strong understanding of costs. We note in this regard that Ofcom has had access to BT's internal pricing papers and found no evidence of difficulties in establishing cost bases for BES or WES.

3.125 As we explain below (§§3.141-3.144) we do not think that forecasting demand and unit costs is that difficult. For instance: the product/market is well developed; BES demand is particularly easy to predict; there is little market share volatility; many costs are variable to demand; and, the nature of common costs sharing reduces risk.

3.126 Thus we do not consider that forecasting costs (say) one year ahead is that difficult. We do not believe that overcharge for three years is necessary to find non-

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[41] BT also use the 'nascency' argument to argue that the allowed WACC should be higher to reflect higher risk. We address this point in §3.136 above

[42] BT produce monthly management accounts (probably) and quarterly statutory accounts. From these accounts it would not be difficult to produce monthly/quarterly estimates of DSAC. For example, BT could calculate the ratio of DSAC to costs (in statutory accounts which are similar to FAC) and apply this ratio to quarterly statutory accounts to come up with DSAC estimates

compliance. It is quite reasonable to find non-compliance if prices are above cost for 6-12 months given that BT could have got regular and timely reports of actual costs.

3.127 Second, if BT had a concern regarding accuracy of its costs forecasts then it should actively managed this by closely monitoring actual costs and making expeditious adjustments in the case where it found that prices were above actual costs. BT is a large and amply resourced company that had the ability to do this. Yet, evidently BT chose not to take such proactive steps to comply. For example, taking the case of BES1000 rental (see Fig 13.2):

3.127.1 In September 2006 when the price was £8,500 BT would (or should) have known that actual DSAC (for 06/07) was likely to be about £2,500. Yet BT did nothing to change prices until June 2007. Even then in June 2007 BT chose to reduce the price only to £6,500 over 2.5 times its view of DSAC (from draft 06/07 RFS)

3.127.2 In August 2007 BT would have definitely known (from the final audited 06/07 RFS) that the DSAC was £2,500. Yet they did not reduce the price of £6,500 until January 2009 (over 18 months later)

3.127.3 Even then in January 2009 BT only reduced the price to £5,000 compared to the then known DSAC cost of £1,700 (from the final 07/08 RFS) i.e. almost three times DSAC

3.128 Third, and in any case, if BT genuinely believed that it could not forecast costs accurately and/or adjust prices to costs then the sensible and diligent response would have been to err on the side of caution and price below the forecast cost ceiling (there is absolutely no need for them to price at or close to the ceiling). BT could have offset the lower price in this case with a higher price for a product that was priced below FAC.

3.129 BT's case seems to be like that of a driver caught breaking the speed limit who thought that their speedometer was inaccurate. In these circumstances it would only be reasonable for it to be the drivers responsibility to ensure they had an accurate speedometer and if not they would be responsible for mitigating the effects by, for instance, driving more slowly.

3.130 We see no reason for any leniency due to possible (though wholly unevidenced) difficulties in predicting costs accurately. To do otherwise would create a highly damaging moral hazard whereby BT can set prices above forecast ceiling creating a rick of overcharge but if the overcharge manifests then BT is not punished.

3.3.3 Practicality

3.131 Ofcom has argued for the use of DSAC since it is more practical than SAC/ combinatorial tests. Ofcom has not though addressed the pertinent question of whether DSAC is more practicable than FAC-based tests (such as FAC+10%).

3.132 We agree with Ofcom (and the CAT) that implementing the SAC/combinatorial tests in practice is 'unworkable' and complex and hence does not lend itself to being deployed in a dispute resolution context. BT seems to accept this.

3.133 Though we agree that DSAC is more practicable than SAC/combinatorial this provides no reason to prefer DSAC over FAC (or FAC+30%). In fact using FAC based ceilings is far more practicable that using DSAC since the FAC numbers are well understood and audited whereas the DSAC numbers are based on BT's LRIC model that is not transparent and unaudited. For instance, Ofcom said recently[43]:

> *However, in the 2005 LLU Statement, we stated that we preferred CCA FAC to LRIC + EPMU, as a <u>more practical and transparent</u> approach to establishing service costs. We considered that LRIC + EPMU, "has the disadvantage of involving a time consuming operation which BT carries out on an irregular basis". <u>Ofcom has limited visibility of how BT generates costs in its LRIC model and the further analysis required by BT to create LRIC outcomes, neither elements of which are subject to an external audit (unlike the RFS)</u>. Furthermore, performance monitoring on a LRIC + EPMU basis against BT's actual financial performance is not straightforward, as the wholesale service profitability information routinely prepared by BT is prepared on a CCA FAC basis. By contrast, CCA FAC uses data that can be reconciled to the RFS. Given that LRIC+EPMU is not conceptually superior to CCA FAC as a cost standard for setting charges and CCA FAC is more transparent we remain of the view that CCA FAC remains preferable to LRIC + EPMU.*

3.134 The lack of transparency and reliability of DSAC data is reinforced by the fact that in this dispute cost adjustments (for instance excluding 21CN costs) can be made to FAC numbers directly but have been unable to be made directly to DSAC numbers (and instead have to be applied as an approximation through a proxy – see §5.32*ff*).

> *DSACs are calculated from BT's LRIC model. We explained in the PPC Final Determinations that while, in theory, BT could produce revised DSAC estimates by re-running its LRIC model using the Ofcom-adjusted regulatory accounting information, <u>such an exercise would be complicated and involve a significant amount of work</u>. Instead, we considered other options for making broad-based adjustments which appear reasonable and proportionate.* (§§12.114, 12.115) (see also PPC Determination §6.137)

3.135 Thus predictability considerations favour FAC (or, say, FAC + 20%) over DSAC. Though they also prefer DSAC over SAC/combinatorial.

3.3.4 Allowed WACC

3.136 BT has argued (see §9.69*ff*) that the allowed WACC for WES/BES products should be higher than that which Ofcom assumes. Ofcom has said that this may be appropriate if BT provides evidence regarding higher risk and uncertainty (§§9.76, 9.78)

3.137 The allowed WACC that is used to calculate WES/BES products is the 'rest of BT' RoBT WACC which was 11.4%[44]. This is effectively derived as follows:

[43] Charge control review for LLU and WLR services Statement 7 March 2012 §3.20
[44] Ofcom's approach to risk in the assessment of the cost of capital Final statement 18 August 2005.

3.137.1 Initially BT Group WACC 10.7%[45] is calculated based on observed BT Group data

3.137.2 This WACC is disaggregated into:

3.137.2.1 lower risk copper access services 10.0% (LLU, WLR) (known as the 'Openreach WACC')

3.137.2.2 Rest of BT services 11.4% (known as 'RoBT WACC'). This effectively includes all other BT services: other wholesale services e.g. interconnection, AISBO, PPC and retail services e.g. residential line, broadband, calls, business networks, IT services, overseas activities

3.138 BT appear to argue that WES/BES warrants a higher WACC (than the RoBT WACC) since there is a risk of demand failure and thus of unrecovered costs. We consider that in practice in this case there is no sound reason to allow a higher WACC. We explain below.

3.139 First, very little WES/BES specific investment is at risk:

3.139.1 Much of the cost is expended in response to demand (e.g. electronics, digs to customer premises)

3.139.2 Many costs that might be unrecoverable from WES/BES in the case of lower than predicted demand could/would be recoverable by BT from other products (e.g. duct)[46]

3.140 Second, even in 2006/07 at the start of the disputed period, demand risk was not high and demand was reasonably well proven. Ofcom has already highlighted a number of reasons for this (§§8.53.1, 8.53.2, 9.81). We would make the following additional observations:

3.140.1 The market for WES/BES products was not a nascent or immature market over this period. Ethernet technology was standardised during the 1980s and has been widely used in the IT and telecommunications sector pretty much ever since. By way of illustration, BT issued its first LES 1000 service description in 2000. LES circuits are based on Ethernet technology and are effectively the forerunner to BES and WES circuits

3.140.2 BES demand in particular is highly predictable since based on number of unbundled exchanges which could be forecast with reasonable accuracy

3.140.3 There was little competition so little market share risk

3.141 Third, BT would only be unable to recover invested/sunk costs in an extreme case of low demand. In cases where demand was lower than estimated then BT could respond to lower demand (and so higher unit costs) by increasing prices (since cost orientated prices are linked to actual costs and given its SMP its prices are not

[45] Ofcom did not directly calculate this but it can be easily calculated

[46] For example, a lower demand could be result of a customer remaining on a PPC / leased line in which case the duct cost would be recovered from PPC / leased line.

constrained by competition). This 'safety net' would only not be effective in recovering costs in extreme cases of low demand.

3.142 Fourth, the RoBT WACC already allows a substantial risk premium which reflects product/demand failure risk. If there was no risk then the allowed return would be the risk free rate (which in this case was 4.6%[47]). Thus in effect there was a substantial 6.8% cost of capital margin to cover risk.

3.143 Fifth, the risk premium that is allowed for AISBO services is probably (if anything) excessive for WES/BES since the RoBT WACC reflects the risks for services that are more risky than WES/BES services. For example:

3.143.1 RoBT includes truly new services such as NGA, IT services, IP networks

3.143.2 RoBT includes services particularly in BT Retail and BT Global Services where there is competitive exposure and thus market share risk

3.143.3 RoBT includes services which are not regulated and so do not have the in-built 'safety net' mechanism that WES/BES enjoyed whereby prices can be set to actual cost

3.143.4 Arguably BES demand has lower risk than LLU components (e.g. co-mingling, MPF, SMPF which have a lower allowed WACC) since BES demand depends on exchange roll-out which is more predictable than customer take-up (which LLU demand depends on)

3.144 Thus we consider that there is no evidential case to justify a higher WACC for WES/BES services than the RoBT WACC that has been applied. In fact probably the opposite is the case, a lower WACC would be appropriate. In any event, it would be for BT to demonstrate what higher WACC would be appropriate.

3.145 It is anyway worth noting that the necessary WACC increase that might be required to reflect higher risk would be plausibly be a few %age points (i.e. 13 to 14% may be) – by way of comparison the additional WACC to cover the large increase in risk from LLU to rest of BT services is just 1.4% Yet, if the WES/BES products were priced at DSAC then the implied WACC would be 41%. It is clearly risible for BT to suggest that it needs a ROCE of 41% to cover extra risk.

3.146 We note that in section 10 (at §10.6*ff*) BT argue that ROCE during the relevant period (06/07 to 09/10) varied between 13.5% and 37.3% and this demonstrates compliance. Ofcom has rightly dismissed this (§10.20). We discuss our view on this at §6.20 below.

3.3.5 SAC / combinatorial tests

3.147 Ofcom has dismissed the use of SAC/combinatorial tests on practicality grounds. We agree with Ofcom view on the practicality. However, and in any case it is useful to

[47] Ofcom's approach to risk in the assessment of the cost of capital Final statement 18 August 2005. Figure 8.3

consider whether SAC/combinatorial tests are relevant to assessing whether prices are economically efficient[48].

3.148 SAC costs are where <u>all</u> costs that are common to a particular product are recovered from that individual product (it is the equivalent of the costs for a firm that only produced this single product). A combinatorial test is essentially the same but for a group of products i.e. where all costs that are common to a product group are recovered from that group of products (we call this 'group SAC').

3.149 SAC tests (individual or group) merely represent the absolute highest cost that might be efficient in very particular (and wholly implausible) set of circumstances. The only circumstance where SAC would be the allocatively most efficient price for a product(s) (and be the outcome in a competitive market) would be if its demand was perfectly inelastic and the all other products was elastic. This is simply implausible in the case of telecom services since the main common costs (e.g. duct) are used to serve the same retail markets (see our discussion above in relation to Ramsey pricing).

3.150 Therefore, even if BT's prices (individual or group) were below individual SAC or group SAC this would say nothing about whether the prices were allocatively efficient. Further, prices at SAC would lead to highly inefficient investment and result in weaker competition (see §3.43*ff* and §3.50*ff* above). Thus, at best SAC can only be a first 'sanity check' in that if prices for are above individual/group SAC then the prices are definitely economically inefficient. SAC can demonstrate inefficiency but it cannot demonstrate whether prices are efficient. If the prices are at SAC it says almost nothing as to whether the prices are economically efficient. SAC tests are a mathematical construct that have little relevance in the real or empirical world (particularly at the individual product level).

3.151 We note that BT has failed in this dispute to produce accurate and detailed SAC/combinatorial test data (PPC Determination §7.121) to show that its charges (both individually and in aggregate) are below those that SAC/combinatorial tests would allow. We suspect this may be because at a group level that it would be evident that BT has indeed over-recovered its common costs.

3.3.6 Summary of other considerations

3.152 In summary regarding the other considerations that have been advanced as being relevant to the testing compliance for cost orientation:

3.152.1 There is no reason of precedent, expectation or regulatory certainty that should bind Ofcom to using a DSAC test alone:

[48] There is one implicit aspect of combinatorial tests that is relevant. In the case the combinatorial test that includes all products the total revenue would need to equal the total cost (i.e. there would be no over-recovery). This aspect of combinatorial tests is clearly compatible with economic efficiency principles.

3.152.1.1 it has always been plainly clear that DSAC was not the only compliance check – DSAC was a 'first order test'

3.152.1.2 it is clear that Ofcom has the discretion to adopt different/additional tests

3.152.1.3 Ofcom cannot anyway fetter its discretion by blindly following an approach it has previously adopted

3.152.1.4 on proper inspection, previous practice (regarding interconnection services, PPC and ISDN) does not support the use of DSAC alone

3.152.1.5 It would be simply absurd for BT to have legitimately expected that Ofcom would have interpreted its cost orientation obligation so as to allow it to substantially overall over-recover costs

3.152.2 WES/BES costs were reasonably predictable and, in any case, if BT felt unable to predict costs reliably and expeditiously adjust prices to align prices with actual costs then it should have erred on safe side

3.152.3 In terms of practicability, FAC (and FAC based tests) are more practicable than DSAC

3.152.4 There is no justification for a higher WACC than has been allowed (11.4%) since this WACC allows ample risk premium to reflect the risk of WES/BES services

3.152.5 SAC / combinatorial costs should be ignored since they say nothing about whether pricing is efficient. It is a mathematical construct that has little relevance in the real

3.153 We outlined above that a DSAC only test was not appropriate 'for the purposes of promoting efficiency and sustainable competition and conferring the greatest possible benefits on the end users'. On proper inspection, none of these other considerations would support the use of a DSAC ceiling alone.

4 Interest

4.1 In this section we consider the question of whether interest should be paid on the overcharge. This section is divided as follows:

4.1.1 Whether the existence of a no interest clause in the contract should over-ride all other considerations ?

4.1.2 Analysis of whether interest should be payable

4.1.3 The appropriate interest rate to apply in this case

4.1 Should no interest clause over-ride other considerations

4.2 Ofcom has reached in a rather cursory manner in a few short sentences (§§14.36-14.37) the initial view that interest should be payable in accordance with the relevant contractual provision. In the case of WES/BES the relevant interest rate is zero and so, under Ofcom's proposed approach, no interest is payable. The relevant contractual term (which we refer to as the 'Interest Exclusion Term') is shown below:

> *"12.3….If a refund is due to the Communications Provider by BT (unless that overpayment results from information provided by the Communications Provider which is not attributable to information provided by BT), the Communications Provider may charge daily interest on late repayments at the [Interest Rate[49]] for the period beginning on the date on which the parties acting reasonably agree BT shall make the repayment and ending on the date BT actually makes payment. If any charge is recalculated or adjusted with retrospective effect under an order, direction, determination or requirement of Ofcom, or any other regulatory authority or body of competent jurisdiction, the Purchaser Parties [sic in Ofcom's document] agree that interest will not be payable on any amount due to either party as a result of that recalculation or adjustment."*

4.3 In Ofcom's draft determination Ofcom does not mention (let alone analyse or weigh) any other factors apart from the contract. Thus Ofcom's implicit reasoning in assessing whether interest should be payable is that the contract is the only relevant factor – in other words the contract over-ride other considerations. Ofcom also takes its position on the basis that it is '*consistent with [its] previous Determinations*'. We consider Ofcom's position legally unsustainable and in particular that it is not open to Ofcom simply to follow its previous practice blindly. We explain below. In particular we assess:

4.3.1 Is Ofcom's approach pursuant to a 'reasoned policy'?

4.3.2 Is Ofcom required to assess whether the term is fair and reasonable?

4.3.3 What is relevance of CAT 080 appeal judgement?

[49] The words "interest rate" are defined as HSBC base rate plus 4% in one version of the relevant contracts. Earlier versions specify the rate from the Late Payment of Commercial Debts (Interest) Act 1998

4.1.1 Is Ofcom's approach pursuant to a 'reasoned policy'

4.4 Ofcom may consider that its approach is pursuant to a 'reasoned policy' to apply what the contract says. If that is the case, then we make the following comments:

4.5 While as a matter of law there is not necessarily any bar to a public authority adopting a reasoned policy, that body of law does not apply to the current case because:

4.5.1 Ofcom's practice in relation to interest is not a reasoned policy but merely something Ofcom happens to have done in previous disputes. If Ofcom wishes to adopt (and then apply) a reasoned policy, it should only do so following a careful consultation through which all stakeholders have had the opportunity to respond[50]. Ofcom plainly has not done this

4.5.2 Even if applying no interest were a reasoned policy, then Ofcom may not simply apply a policy blindly but must have regard to the particular aspects of the case and the representations made to it[51]

4.6 To the extent that Ofcom's practice in relation to interest does constitute a reasoned policy to which it may have regard, TalkTalk contends that it is wrong in principle and/or is wrong to apply in this case for the reasons set out in more detail below.

4.1.2 Is Ofcom required to assess whether fair and reasonable?

4.7 We consider that Ofcom is required pursuant to its s186 duties to resolve dispute to assess whether the Interest Exclusion Term (on which Ofcom draft determination relies) is fair and reasonable. We explain below.

4.8 The question of interest and the Interest Exclusion Term is squarely within the scope of the dispute[52]. It was always clearly part of the dispute that TalkTalk claimed interest. For instance its Joint Dispute Submission, Sky and TTG asked that Ofcom give a direction requiring BT:

> *to repay to the Purchaser Parties a sum equal to the difference between the amounts paid by them in respect of the Relevant Charges, and the amounts which they would have paid had those charges been no higher than if they had been set in accordance with Condition HH3.1, <u>together with interest on that sum</u> at such rate and for such period as may be appropriate and just; or alternatively,*

[50] See, for example, Ofcom's policy in relation to pensions deficit repair payments, (Pensions Review, Statement, 15 December 2010)

[51] See, for example, *R v SoS for the Environment Transport and the Regions* [2001] UKHL 23 [2003] 2 AC 295: "*What is crucial is that the policy must not fetter the exercise of the discretion. The particular circumstances always require to be considered*."

[52] We have noted Ofcom's provisional conclusions in relation to Verizon's dispute, on similar subject matter (Ofcom document dated 4 April 2012) in which it declined to deal with the interest issue on the basis that "*whether the contractual terms on which BT provided the services were fair and reasonable is outside the scope of this Dispute*" (and distinguishing it, on that basis, from the PPC Payment Terms dispute). However, this scope is different to this dispute. We do not, in this document, comment on Verizon's dispute directly

to repay to the Purchaser Parties such other amounts as Ofcom may determine to be appropriate and just.‖

4.9 Though interest was not specifically referred to in the short-form scope published on Ofcom's website it is obvious that it was not excluded and the scope is drafted in such a way as to require Ofcom to have regard to all such matters as are relevant in deciding the dispute. In short, the Interest Exclusion Term is no more 'out of scope' than the substantive questions relating to the amount of overcharge.

4.10 Since the question of interest is clearly in dispute, Ofcom must resolve it, pursuant to its duty in s186 of the Act. In doing so, it must reach a view on the fairness and reasonableness of the Interest Exclusion Term (and BT's compliance with Condition HH1). Ofcom cannot simply refer to its previous practice. Failure to do so will constitute an unlawful fettering of discretion, particularly since Ofcom has apparently not considered the representations made by TalkTalk and Sky on this point on 11 August 2011. This is also consistent with the TRD decision[53] which made clear that Ofcom's decision under section 190 must take account what is fair and reasonable.

4.1.3 Relevance of CAT 080 appeal judgement?

4.11 We understand that Ofcom's view that contractual rights over-ride other factors may have been based on the CAT judgement in BT's 080 appeal ([2011] CAT 24) which considered the role of contractual rights. It is therefore probably useful to consider that judgement.

4.12 In that case BT had increased 080 termination rates which was in accordance with BT's contractual rights. The increase had been disputed by the mobile operators and in resolving that dispute Ofcom considered that the price increase was not appropriate. BT appealed that dispute determination. In its judgement the CAT decided that the increase was appropriate.

4.13 TalkTalk disagrees that this case provides a relevant precedent that applies to the current case. The two cases were fundamentally different because, in the 080 Appeal, in contrast to this matter, BT did not have SMP in respect of the disputed product. The CAT itself pointed out that this was an important consideration in its judgment.

4.14 Without prejudice to that point, however, even if Ofcom were to apply to the approach taken by the CAT in the 080 case, the correct conclusion would be that contractual rights are not (as Ofcom seems to contend) the only relevant factor and further other relevant considerations can over-ride contractual rights. We explain why in the following paragraphs.

[53] Cable and Wireless &Ors v Ofcom (Termination Rate Disputes), [2008] CAT 12, §181

4.15 Regarding whether the contract is the only relevant consideration, the CAT made plainly clear that though contractual rights were relevant other factors were also relevant and that these could override a contractual right (at §241):

> *We consider that BT's rights and obligations under the Standard Interconnect Agreement to be a potentially relevant factor. Before us, no-one seriously questioned this as a matter of general principle. Equally, it was common ground before us that OFCOM had – as part of its powers under the dispute resolution process – the power to override contractual arrangements made by the parties before it.*
>
> *Thus, whilst we certainly do not suggest that private law rights can dictate the outcome of the Dispute Resolution Process (as we have held, the Dispute Resolution Process can override such rights), private law rights are relevant factors to take into account. (§444)*

4.16 The CAT has explicitly found this to be the position in other judgments, for example:

> *..many SMP conditions comprise a public law "overlay" qualifying or altering the strict legal rights of the parties. Where this occurs, private law rights give way to regulation.*[54]

4.17 The resulting secondary question that must be assessed is whether and in what circumstances should Ofcom override a contractual right. The CAT said (§241):

> *The more difficult question – considered in Section M below – is if there is a clear contractual right in a person, in what circumstances is it right for OFCOM to override it?*

4.18 Instructively the CAT went on (§198) to outline eight factors[55] in addition to contractual rights that should be considered in assessing the appropriate termination rate. These were:

4.18.1 Ofcom's general statutory obligations under the 2003 Act

4.18.2 Ofcom's "policy preferences"

4.18.3 BT's rights and obligations under the Standard Interconnect Agreement

4.18.4 Regulatory obligations and duties on the parties to the dispute

4.18.5 Welfare assessment

4.18.6 The effect on competition

4.18.7 The ability of mobile network operators to recover their efficient costs

4.18.8 Practicality

4.18.9 The nature of the Dispute Resolution Process

4.19 The CAT analysed each of these factors in depth (across 80 pages). In the 080 case the conclusion the CAT reached was that since the other relevant factors were generally inconclusive (for example, see §§442, 448) the 080 termination rates

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[54] In BT and Everything Everywhere v. Ofcom, Neutral citation [2011] CAT 24: combined Cases 1151/3/3/10, 1168/3/3/10, 1169/3/3/10, at paragraph 444

[55] It identified two other factors but considered them not relevant (BT's motivation in introducing NCCNs and forthcoming review of non-geographic numbers). In its conclusion (at §439ff) the CAT grouped its analysis around three principles

should be based on BT's rights under the contract. The CAT did not conclude (and could not have) that contractual rights always over-ride other factors.

4.20 Four points arise from the CAT's analysis:

4.20.1 It is necessary to properly consider other relevant factors. Ofcom's failure to analyse other factors looks starkly misplaced

4.20.2 Contractual rights are relevant but are only one factor

4.20.3 The other factors quite properly (and unsurprisingly) take into account Ofcom's statutory obligations and the impact on consumers, competition and economic efficiency

4.20.4 The conclusion is fact sensitive

4.21 It should not be surprising Ofcom has many duties that override contractual provisions. If Ofcom couldn't it would be a rather toothless regulator and would mean that Ofcom was effectively contracting out to BT Ofcom's power to decide on and award interest. It cannot possibly have been Parliament's intention to allow this.

4.22 In summary, we do not think the 080 case is relevant but even if it were then it does not support Ofcom's position that contractual rights over-ride other considerations.

4.1.4 Summary

4.23 In summary, Ofcom cannot simply duck the question of whether interest should be payable and what interest rate should apply by relying on a contractual term. If the contractual term is not of itself fair and reasonable, then the resolution of the dispute will not be fair and reasonable. Ofcom must therefore consider all relevant factors and in particular properly assess whether the Interest Exclusion Term is fair and reasonable and in accordance with Condition HH1 considering the circumstances of the current case.

4.2 Should interest be payable?

4.24 As we explained above, in coming to its decision regarding whether interest should be payable Ofcom must consider whether the Interest Exclusion Term is fair and reasonable which may reflect a wide range of factors including its statutory obligations, economic factors and competitive effects as well as contractual rights. Below we consider these other factors. We conclude that in light of these considerations Ofcom should in fact award interest on any over-charge.

4.25 First, the Interest Exclusion Term is in breach of the requirement that BT provides network on 'fair and reasonable terms' pursuant to Condition HH1.2 (2004 and 2008 reviews[56]). A contract term which awards an unfair working capital advantage to BT

[56] 2004 Condition: "HH1.2 The provision of Network Access in accordance with paragraph HH1.1 shall occur as soon as reasonably practicable and shall be provided on fair and reasonable terms,

is unreasonable and is therefore contrary to BT's obligation to contract on fair and reasonable terms. This is a hard obligation on BT – it is not one that can be signed away by CPs.

4.26 This principle was established by Ofcom in the PPC Payment Terms dispute (CW/00916/08/06). In that dispute, the contractual term/right at issue required that CPs pay quarterly in advance. As with the Interest Exclusion Term, this term imposed terms relating to payment which conferred a working capital benefit on BT and a working capital detriment on CPs (in essence because CPs were required to pay up front for PPCs on a quarterly basis). The case of the main disputing party, Thus, was described by Ofcom (in the explanatory document to its determination of 25 January 2007) as follows:

> *[the] terms simply reflect what BT was able to impose on its customers at the time the product was launched by virtue of its significant market power"…BT's current payment terms are not fair and reasonable because they impose an additional cost on purchasers as a result of the impact on working capital.*

4.27 The same is true in the current case – but in relation to interest applicable to retrospective adjustments following an Ofcom determination, rather than date of payment.

4.28 In the PPC Payment Terms dispute, Ofcom found that the term was not fair and reasonable. Ofcom ordered that BT should make a repayment to Thus "*calculated on the basis of the total cost of capital which BT avoided as a result of [the effects of the unreasonable term]*". In other words, Ofcom set aside a term which formed part of the signed contract and replaced it with a fair and reasonable term instead. The same applies here. Also, it is relevant that the repayment was based on an interest rate which reflected the capital costs that BT avoided as a result of it non-compliance (i.e. the avoided marginal cost of additional debt/equity) and accordingly the interest rate applied was BT's WACC.

4.29 <u>Second</u> and in any event, CP's (including TalkTalk) did not agree the Interest Exclusion Term on a proper commercial basis and in any real sense. It is unrealistic in the extreme to approach BT's reference offers as if they genuinely represent terms that the parties have agreed and are the result of a balanced bargaining process that will result in fair terms. BT, as a player with significant market power, is in effect able to impose broadly whatever terms it likes. Ofcom cannot simply fall back on what the contract between BT and the other disputing party may or may not say in particular when one party as here TalkTalk disputes that the contract is fair and reasonable.

4.30 Further, in this case, such evidence as exists of discussion relating to this term shows that it was not agreed. For example, see the extract in Annex C, from the 2008

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conditions and charges and on such terms, conditions and charges as Ofcom may from time to time direct." 2008 Condition: "HH1.2 The provision of Network Access in accordance with paragraph HH1.1 shall occur as soon as reasonably practicable and shall be provided on fair and reasonable terms and conditions (excluding charges) and on such terms and conditions (excluding charges) as Ofcom may from time to time direct."

contract negotiations. Although TalkTalk did ultimately sign various contracts containing the Interest Exclusion term TalkTalk certainly did not consider the term reasonable[57]. We consider that the fact that TalkTalk signed the contract has little weight since, due to BT's SMP TalkTalk had little or no commercial choice but to sign up to the contract in order to receive the service to allow TalkTalk to roll out its local loop unbundling network (thereby increasing retail competition in broadband and telephony markets).

4.31 Third, the Interest Exclusion Term is properly to be understood as an exclusion or limitation clause (i.e. a clause that seeks to limit or exclude one party's liability in some way) and does not pass the fair and reasonable test under the Unfair Contract Terms Act 1977. Because of their inherent capability of being unfair or unreasonable, these clauses are subject to stringent controls under UK law and the clause must therefore be treated with great caution by Ofcom. The Unfair Contract Terms Act 1977 severely restricts the effect of limitation and exclusion clauses in standard terms and an application of the principles in that Act are highly illuminating in the current case. The 1977 Act sets out a reasonableness test for such clauses. That test must, according to the 1977 Act itself, be taken into account in assessing whether the Interest Exclusion Clause meets the fair and reasonableness requirement in BT's SMP Conditions.

4.32 Section 11(4) of the 1977 Act says as follows:

> *(4) Where by reference to a contract term or notice a person seeks to restrict liability to a specified sum of money[58], and the question arises (under this or any other Act) whether the term or notice satisfies the requirement of reasonableness, regard shall be had in particular (but without prejudice to subsection (2) above in the case of contract terms) to—*
>
> *(a) the resources which he could expect to be available to him for the purpose of meeting the liability should it arise; and*
>
> *(b) how far it was open to him to cover himself by insurance.*
>
> *(5) It is for those claiming that a contract term or notice satisfies the requirement of reasonableness to show that it does.*

4.33 Three points arise from this.

4.33.1 First, these terms of the 1977 Act apply to an assessment of reasonableness under any Act, including the 2003 Act;

4.33.2 Second, it is for BT to prove reasonableness; and,

4.33.3 Third, (in relation to the substantive point at issue), subsection 4(a) specifies that regard must be had to the question of the resource to which a person may have access in meeting the liability. Since in the current case it is BT which has had the benefit of the avoided capital costs (and, conversely,

[57] It is important to recognise that the Interest Exclusion Clause is only ever likely to work in BT's favour since it is implausible for an increased charge (as against a decreased charge) to result from the 'recalculat[ion] or adjust[ment] with retrospective effect under an order, direction, determination or requirement of Ofcom …'.

[58] In this case, of course, the amount being zero

TalkTalk's capital costs have increased), BT is clearly in a better position to bear that liability.

4.34 Section 11 also specifies that regard must be had to the guidance on reasonableness in Schedule 2 of the 1977 Act, which specifies the following criteria for assessing reasonableness. In the table, we assess their application to the current case:

Consideration set out in Schedule 1 of the 1977 Act	**Application to current case**
The strength of the bargaining positions of the parties relative to each other, taking into account (among other things) alternative means by which the customer's requirements could have been met;	BT enjoys SMP and there are no other alternative means by which the requirement could have been met. Conclusion – term is not reasonable
Whether the customer received an inducement to agree to the term, or in accepting it had an opportunity of entering into a similar contract with other persons, but without having to accept a similar term;	Neither of the cases applies to this contract. Conclusion – term is not reasonable
Whether the customer knew or ought reasonably to have known of the existence and extent of the term (having regard, among other things, to any custom of the trade and any previous course of dealing between the parties);	In other contracts, the equivalent terms provide for the opposite (i.e. that interest <u>is</u> payable). Conclusion: neutral
Where the term excludes or restricts any relevant liability if some condition is not complied with, whether it was reasonable at the time of the contract to expect that compliance with that condition would by practicable;	The term purports to restrict liability which arises on a decision by Ofcom which would often be founded (as in this case) on analysis of whether BT has complied with its regulatory obligations. Compliance with those obligations was <u>of course</u> practicable. Conclusion – term is not reasonable
Whether the goods were manufactured, processed or adapted to the special order of the customer.	n/a

4.35 The only sensible inference from the application of the criteria in the 1977 Act is that the Interest Exclusion Term is not reasonable.

4.36 In conclusion in relation to the provisions of the 1977 Act:

4.36.1 The Act either applies (in relation to subsection 4 of section 11) or is highly instructive (in relation to Schedule 2) in relation to the reasonableness test;

4.36.2 It is for BT to prove that it meets the requirement of reasonableness; and

4.36.3 The tests in the Act make it overwhelmingly clear the Interest Exclusion Term is not reasonable

4.37 Fourth, in considering the question of interest Ofcom must take into account its other duties and particularly economic efficiency and incentives. In particular Ofcom needs to address two particular issues that are consistent with the principle of restitution. The first of these is that the compliance approach should create incentives to comply. Ofcom itself describes these incentives as being of 'real importance' (§14.24):

> *In applying section 190(2)(d) of the Act, we consider that BT should not unfairly retain any overcharge, as this could provide a disincentive for it to comply with its regulatory obligations. We believe that the incentives and regulatory signals that determinations in disputes of this nature send to BT (and other CPs) as to how we will interpret regulatory obligations and assess future conduct are of real importance.*

4.38 In other words, Ofcom should ensure as best it can that all BT's gains resulting from non-compliance are 'confiscated' from it so that non-compliance is not a profitable for it to pursue.

4.39 The second and related issue is that retail and wholesale customers should, as far as possible, be compensated for the losses they have suffered.

4.40 In this context it is necessary to consider the other gains and losses in addition to the monetary value of the overcharge itself:

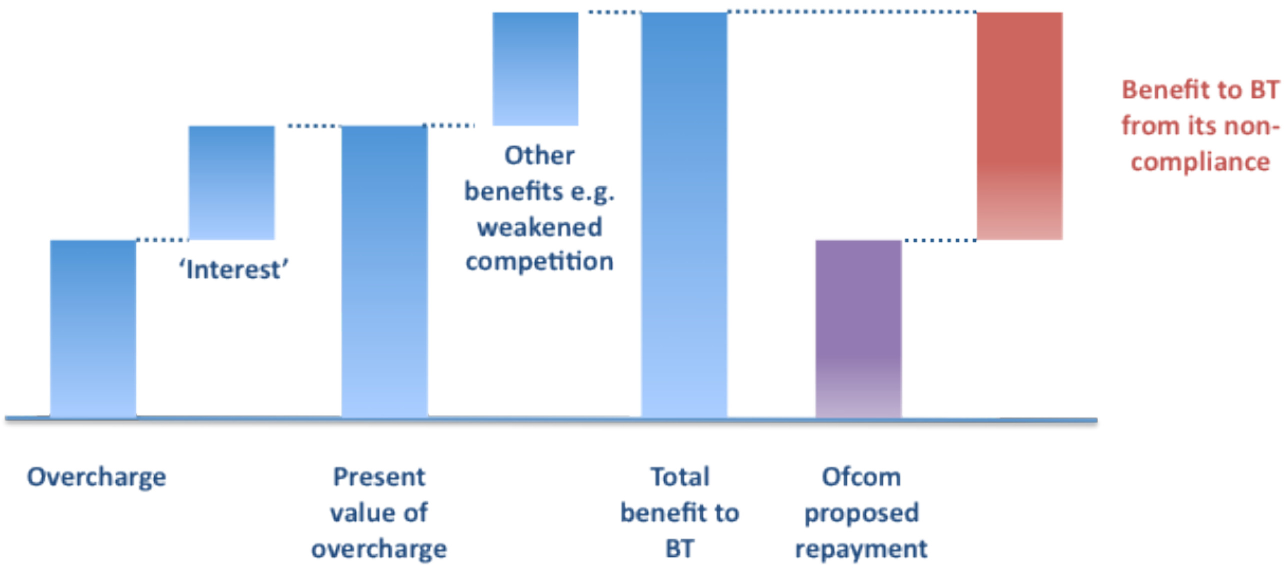
4.40.1 The benefit enjoyed by BT due to avoided capital costs in that it did not (at the margin) need to raise £120m in debt/equity. The rate to value avoided capital costs is effectively BT's WACC of 11.4%

4.40.2 Other benefits that BT enjoyed in addition to the then monetary value of overcharge itself e.g. weakened competition against its retail activities, higher market share, higher retail prices

4.40.3 Other costs that wholesale and/or retail customers suffered in addition to the then monetary value of overcharge itself e.g. reduced return on investment, less competition, choice, innovation

4.41 The 'stack' of benefits for BT resulting from its non-compliance is shown in the diagram below. By setting the repayment to only include the overcharge itself (without any interest) means that BT will only pay back a fraction of the benefits that it has enjoyed.

Benefit enjoyed by BT (NPV 2012)



4.42 Ofcom's approach of only requiring BT repay the overcharge essentially sends a signal to BT that non-compliance is a profitable strategy for them to pursue. If BT are found out (which is not guaranteed) then the worst outcome is that they will have to pay back a proportion of the benefits they enjoyed. This is neither an appropriate approach for a regulator to take given its dreadful incentive properties nor is it fair (since customers will only be refunded a proportion of the harm they suffered).

4.43 In order to ensure fairness and restitution and create compliance incentives Ofcom must include interest. This should be calculated using BT's WACC since only by using WACC will this properly reflect the avoided capital costs that BT enjoyed[59].

4.44 Further, and in order to ensure fairness, full restitution and create more effective compliance incentives, Ofcom should consider other steps to help ensure that the amount repaid is as close as possible the total benefits that BT enjoyed:

4.44.1 Erring on the high side in calculating the overcharge. For instance:

4.44.1.1 assessing overcharge on individual products using a FAC+20% ceiling rather than a FAC+30% ceiling

4.44.1.2 calculating the overcharge at FAC but only on products where price was above DSAC

4.44.1.3 using a proportionate method to calculate the DSAC adjustment

[59] In essence using BT's WACC will mean that BT refund the present value to them of the overcharge and the value they have enjoyed today by avoiding the need to raise equity and debt.

4.44.2 Considering whether there is a mechanism for including an amount for repaying other benefits that BT enjoyed so that they are 'confiscated' from BT

4.45 Not including interest and/or using an interest rate that is less than BT's WACC also creates (as well as an incentive for non-compliance) a strong incentive for BT to delay resolution of the dispute since the later the dispute is resolved the greater the avoided capital costs BT enjoy. This incentive has been amply shown in the way that BT has dragged out the dispute resolution so far including most recently requesting a two week delay in the responses to the Draft Determination. Ofcom's approach of requiring no inertest is repaid (or setting an interest rate below WACC) rewards BT for such abusive behaviour.

4.46 TalkTalk believes that the above grounds, whether individually or jointly without prejudice to each other, support the conclusion that the Interest Exclusion Term is neither appropriate nor fair and reasonable which means that Ofcom cannot rely on this contractual provision in order to discharge its dispute resolution duties under the Communications Act 2003.

4.3 Appropriate interest rate

4.47 The setting aside of the Interest Exclusion Term means that Ofcom needs to address the question of what interest should apply in this case. There are number of ways to look at the issue of what interest rate should apply. We discuss these below:

4.48 Consistent with the PPC Payment Terms dispute, the principles of restitution and fairness and the need to create effective compliance incentives, the most appropriate rate would be the relevant BT cost of capital (i.e. RoBT WACC of 11.4%) or, alternatively, the TalkTalk WACC which may be higher[60]. Applying the 11.4% as the interest rate would mean that the total amount repaid would increase by £76m (assuming the same overcharge as Ofcom has calculated).

4.49 An alternative (albeit inferior) would be to use an interest rate that is used in the same WES/BES contracts but for other circumstances. For instance, in the 2008 version of the BES contract, the first part of clause 12.3 provides that interest on late payments should be payable at the prevailing rate in the Contracts (Late Payment of Commercial Debts) Act, which is the Bank of England base rate plus 8%. In a later version, the Interest Rate is a defined term (HSBC base rate + 4%). In any event, though, once the last sentence of 12.3 drops away, the first part of 12.3 would appear to apply[61]. Applying an interest rate of Bank of England plus 8% would

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[60] The TalkTalk WACC during the disputed period is likely to be higher than the RoBT WACC since TalkTalk was a start-up and, unlike RoBT, TalkTalk includes no businesses where it has SMP

[61] "*If a refund is due to the Communications Provider by BT (unless that overpayment results from information provided by the Communications Provider which is not attributable to information provided by BT), the Communications Provider may charge daily interest on late repayments at the Interest Rate for the period beginning on the date on which the parties agree BT shall make the repayment and ending on the date BT actually makes payment*."

increase the total amount to be repaid by £64m (assuming the same overcharge as Ofcom has calculated).

4.50 A second alternative is to use an interest rate from another contract for network access that applies in the case of overcharges. The most frequent rate used is 'Oftel Interest Rate' which is set at LIBOR + 3/8ths %. For example:

> BT Standard Interconnect Agreement: *"12.7 If any charge (or the means of calculating that charge) for a BT service or facility has retrospective effect (for whatever reason) then BT shall, as soon as reasonably practicable following publication in the Carrier Price List, adjust and recalculate the charges in respect of such service or facility using the new charge and calculate the interest for any sum overpaid or underpaid at the Oftel Interest Rate."*[62]
>
> Revised Access Network Facilities Agreement: *"11.7 If any charge (or the means of calculating that charge) has retrospective effect (for whatever reason but including without limitation by reason of a determination) that charge shall as soon as reasonably practicable be adjusted and recalculated and interest shall be payable for any sum overpaid or underpaid at the Oftel Interest Rate from the date of over or underpayment to the date of refund or payment in full."*[63]

4.51 Applying this interest rate would mean that the total amount repaid would increase by £15m (assuming the same overcharge as Ofcom has calculated).

4.52 We consider the precedent of the PPC Payment Terms dispute, the principles of restitution and fairness and the need to create effective compliance incentives the most suitable rate is the RoBT WACC. If that is not used then the Bank of England + 8% is second best. The Oftel interest rate is wholly inadequate in these circumstances.

4.53 We think it relevant to note why there are different interest rates in contracts. BT has pushed for a higher interest rate on late payments by customers than for overcharges since, according to BT, late payments are more controllable. We would argue that the overcharge in the WES/BES case was in fact highly controllable (after all BT set the prices) and therefore there is no reason to use a lower rate than the interest rate for late payments.

4.4 Summary

4.54 TalkTalk believes that Ofcom has erred in its provisional conclusion that interest should simply be payable in accordance with the contract (which excluded interest). The question of interest is squarely within the scope of the dispute and therefore in order to discharge its dispute resolution duties under s186 of the Act, Ofcom needs

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62 https://www.btwholesale.com/pages/static/Library/Pricing_and_Contractual_Information/Telephony_Reference_Offer/index.htm

63 http://www.openreach.co.uk/orpg/home/products/llu/downloads/RANF_main_body_issue3.2_291209.pdf

to assess whether it is fair and reasonable to award interest on the overcharged amount and if so the level of interest rate that should be applied.

4.55 Ofcom may consider that contractual rights over-ride other factors based on the CAT judgement in BT's 080 appeal ([2011] CAT 24). TalkTalk disagrees that this case provides a precedent that applies to the current case. The two cases were fundamentally different because, in the 080 Appeal, in contrast to this matter, BT did not have SMP. Even if the 080 case were relevant then the case does not in fact support Ofcom's position that contractual rights over-ride other considerations.

4.56 TalkTalk submits that it would be fair and reasonable that interest should be awarded and that the interest rate used should reflect the capital cost benefit enjoyed by BT. Ofcom has previously stated in the PPC payment term dispute that a contractual payment term can be replaced by Ofcom's own consideration of what is fair and reasonable as between the parties and that BT is not entitled to a capital cost benefit on the basis of what it has been able to include in an SMP product contract by virtue of its market position. In addition, it is abundantly clear that the current BES/WES contract in so far as the Interest Exclusion term is concerned does not represent a balanced commercial agreement between TalkTalk and BT. Nor is it compatible with Ofcom's wider statutory obligations such as ensuring that there are incentives to comply.

4.57 As to the level of interest rate that should be used to calculate the amount of interest, TalkTalk believes that the rate should be BT's WACC which best reflects the avoided capital costs that BT enjoyed and creates the best possible incentive on BT not to overcharge in breach of its cost-orientation obligation.

5 Appropriate cost data for assessing cost orientation

5.1 This section of TalkTalk's response addresses sections 11 and 12 of Ofcom's draft determination regarding the calculation of DSAC costs which Ofcom has used as its benchmark to assess cost orientation and the overcharge. Our comments in this section are without prejudice to our view that a DSAC test only is inappropriate as a means to test compliance and assess an overcharge.

5.2 In line with Ofcom's approach we discuss the following issues

5.2.1 BT proposed revisions to the DSAC model

5.2.2 Corrections to base data errors such as volumes

5.2.3 Adjustment to FAC costs as per adjustment in 2009 Leased Line Charge Control

5.2.4 Consequential adjustment to DSACs

5.3 The enclosed report from RGL has analysed these adjustment in detail.

5.1 BT proposed revisions to the DSAC model

5.4 BT argues that the DSAC figures in its annual published RFS are unreliable and that Ofcom should instead use a revised DSAC model that BT has produced for the purposes of this dispute. It comes as no surprise of course that the DSAC values in BT's new model are significantly higher than those published in the RFS thereby reducing the amount of the overcharge by BT.

5.5 TalkTalk agrees entirely with the principled and methodological approach adopted by Ofcom in concluding that BT's revised DSAC model should be rejected and that it is fair and reasonable for Ofcom to rely on the published RFS instead (unless there are clear arithmetic, input or software errors but even then the onus should be on BT to show that they could not reasonably have discovered those before).

5.6 This is a very important principle that Ofcom is establishing. The production and publication of accurate and reliable regulatory accounts in its RFS is a separate regulatory obligation on BT and one that BT cannot be allowed to take lightly. BT is now effectively saying that the DSACs it previously published and warranted as correct are in fact wrong. BT is accepting that it has breached its regulatory obligation which is quite extraordinary. Although BT has a large amount of discretion as to how it calculates costs particularly DLRIC and DSAC, once it has published the costs in the RFS, it would make a charade of the regulatory obligation if BT were able to change them after the event at its own discretion.

5.7 Apart from the principle of making sure that BT complies with its obligation to publish the RFS, it goes without saying that the RFS play a pivotal role in allowing CPs to identify potential overcharging and bring disputes. The RFS allowed TalkTalk to analyse the relationship between BT's charges and costs without possessing detailed knowledge about the underlying (and confidential) cost data. This enabled TalkTalk to approach Openreach in the first place to commence commercial negotiations in 2008. It is of fundamental importance that competitors to BT can have confidence that the published RFS are accurate but equally important that they will not be subject to change after the event (aside of arithmetic errors).

5.8 BT argue that the DSAC numbers are unsound since there is an instance of FAC exceeding DSAC (i.e. BES100 rental in 2006/7). With regard to the relationship between DLRIC, FAC and DSAC, TalkTalk agrees with Ofcom that these cost values should generally be in ascending order of magnitude in relation to each other. Whilst TalkTalk generally believes that DSAC provides a too loose pricing constraint on BT, we accept that the overall objective should be to provide suitable limits on BT's pricing in SMP markets. The fact that FAC may exceed DSAC is a function of how BT has chosen to calculate these values and does not indicate a problem with the underlying principle of providing a pricing constraint on an SMP provider. Ofcom is correct to point out that in this case, there is only one instance of FAC exceeding DSAC (i.e. BES100 rental in 2006/7) which does not suggest any issue of principle as to how BT calculates these values. It is of course the case that the single example identified occurred 6 years ago yet curiously enough it is only now in this dispute that BT has chosen to raise the issue.

5.2 Corrections to the base data associated with volume errors

5.9 We note that Ofcom (§§12.42*ff*) has made the following corrections to the 'base data' (§12.42):

- 5.9.1 correcting the 2006/07 and 2007/08 unit FACs and DSACs;
- 5.9.2 correcting for volume errors relating to WES services in 2006/07;
- 5.9.3 correcting issues associated with volume errors for BES1000 rental and BES1000 connection in 2008/09; and
- 5.9.4 correcting for a revenue error associated with main link in 2008/09.

5.10 We agree that is appropriate to correct these 'arithmetic' errors. We would though note that it is rather worrying that BT's previously published RFS included such basic errors.

5.11 These corrections have been based on statements made by BT in its response to a formal information request by Ofcom. The underlying data has not been available to TalkTalk and/or RGL for further analysis. Given that we have not had access to the BT's response to the information request, we are unable to confirm whether the adjustments can be considered correct or reasonable.

5.12 Further, we note that it is possible that BT has only disclosed certain errors and that more errors make exist that are against BT's interests.

5.3 Adjustments to FAC costs in line with 2009 Leased Line Charge Control

5.13 We note that Ofcom (§§12.57*ff*) has considered adjustments to FAC to "*replicat[e] a series of cost adjustments that were identified in the 2009 LLCC Statement, to the extent that they are applicable to these historic Disputes*.". The areas of change were:

5.13.1 transmission equipment costs;

5.13.2 21CN costs;

5.13.3 ancillary services;

5.13.4 payment terms;

5.13.5 treatment of holding gains/losses; and

5.13.6 RAV adjustment.

5.14 Ofcom has concluded that adjustments are appropriate in relation to the first four but not in relation to the last two factors. We discuss our view on these below.

5.3.1 Transmission equipment costs

5.15 We consider that it is appropriate to make these adjustments. We also note (though beyond scope of this dispute), that the RFS should routinely include these type of adjustments to apply similar accrual methods to revenues and costs.

5.16 In relation to transmission equipment costs, RGL concludes that the adjustment made by Ofcom appears to increase BES connection costs but decrease rental costs. RGL has based its analysis on data from the LLCC statement for 2006/7 and 2007/8 respectively. Given that Ofcom has not granted access to the actual data underlying this adjustment, it is impossible for TalkTalk to comment on whether Ofcom's approach is correct or reasonable.

5.3.2 21CN costs

5.17 We agree that 21CN costs should be excluded and that the linked 21CN overhead allocation should also be excluded. This appears a reasonable approach and in line with the Competition Commission's view in the 2009 LLCC appeal where it stated that:

> *"a reduction in MCE as a result of the 21CN adjustment should have been followed by an adjustment to the overheads that were allocated on the basis of MCE."* (§12.75)

5.18 RGL cannot comment on the calculation itself since the numbers have not been disclosed.

5.3.3 Ancillary services

5.19 In relation to ancillary services (excess construction charges), this adjustment had been made by RGL although RGL had allocated it to both connections and rentals using operating costs as a driver. In contrast Ofcom has applied the adjustment to rental costs only on the basis of volumes. While Ofcom's approach might be slightly counterintuitive, TalkTalk does not believe it is an unreasonable one.

5.3.4 Payment terms

5.20 In relation to payment terms, TalkTalk notes Ofcom's methodology and believes it appears reasonable.

5.3.5 Treatment of holding gains/losses

5.21 Ofcom proposes not to change BT's reported treatment of the holding gain associated with duct in 2009/10 principally on the basis that the holding gain "*results from a change in accounting estimate rather than, for example, an in-year change in the cost of labour or materials associated with building duct*." (§12.96) As a result, Ofcom considers that "*the combination of the nature and size of the holding gain would result in an artificial upwards distortion of returns in 2009/10 if it was reflected in unit costs.*"

5.22 BT support Ofcom's approach – in its 2009/10 RFS, BT argue that:

> *"whilst this large holding gain has been recognised in 2009/10 it does not represent a genuine periodic change in the valuation of the duct assets. BT believes that it results in an artificial upward distortion of returns in the year."*[64]

5.23 TalkTalk believes that Ofcom's proposed approach is wrong and its underlying reasoning flawed.

5.24 The holding gain was caused by an upward revaluation of BT duct assets. BT will benefit from the increased value of its duct assets through a £200m increase in future capital costs (depreciation and ROCE) for AISBO services. Therefore, if the holding gain is ignored, BT will over recover its costs as a result of the revaluation. In other words, the holding gain may be based on just a 'change in accounting estimate' but has a consequential and real economic benefit for BT whose costs increase and, as a result, can charge higher prices in SMP markets.

5.25 Our concern is that there is a lack of methodological consistency with regards to the treatment of the revaluation, with the increased (future) capital cost being included in costs but the associated holding gain being disregarded. That this revaluation arose as a result of a 'change in accounting estimate' provides no reasons for an inconsistent approach.

[64] BT RFS 2010, p18

5.26 Clearly, if the resulting holding gain is allocated across a single year (2009/10), this would result in a significant change (reduction) to the costs in the RFS. This may be undesirable as BT would be facing a large reduction in costs which, arguably, it may have been unaware of when setting prices.

5.27 Recognising the need for a consistent approach, we consider there are three options for the treatment of this:

5.27.1 First the revaluation can be ignored meaning that there will be no holding gain and no increase in future capital costs which will avoiding any potential inconsistencies

5.27.2 Second, the revaluation could be included but the holding gain spread forward. Applying it in this fashion, however, would risk negating the effect of the revaluation completely. If the new approach is a better representation of replacement cost on a future looking basis, applying the holding gain in this way would remove the benefit of having a more accurate valuation methodology.

5.27.3 Third, the revaluation could be included but the holding gain spread backward to the years before 09/10. This will reflect the gradual change in the environment for laying duct and this 'smoothing' effect on costs will reflect the actuality of the theory behind the accounting change.

5.28 Ofcom must adopt a methodology to implementing the revaluation that is internally consistent or ignore the valuation – Ofcom's current approach Ofcom is half pregnant and allows BT to have its cake and eat it.

5.3.6 RAV adjustment

5.29 We understand that the RAV adjustment relates to the valuation of the access network (duct and copper). Ofcom proposes not to make no adjustment for the RAV on the basis that (§12.99):

5.29.1 Ethernet services are provided entirely over fibre; and

5.29.2 Ethernet services make less use of pre-1997 duct since they were introduced after 1997.

5.30 In the case of BES we agree with Ofcom that BES services are likely to make little use of access duct. To the extent that BES does use access duct there remains an argument for a limited RAV adjustment.

5.31 However, the RAV adjustment is relevant to WES services since these services use access duct. We do not consider that Ofcom is correct in effectively concluding that WES services will make no use of pre-1997 duct assets on the basis that Ethernet services were introduced after 1997. The reality is that WES circuits will make extensive use of pre-1997 assets. WES circuits will, for the most part, use duct routes that were in place before 1997 (as do other access products such as TI). The majority of the network investment after 1997 (and so pst-97 assets) will be for maintaining and upgrading the existing duct routes. It is not the case that post-1997 investment (and assets) are made in a different set of ducts that only WES services use (except extensions to the network to new premises/sites). Thus we consider that it is appropriate to fully apply the RAV adjustment (or at least 75% of it). We note that if the RAV adjustment on WES/BES services is less than 100% then this 'under-adjustment' must be offset with a greater adjustment on other services.

5.4 Ofcom's approach to adjusting BT's DSAC

5.32 Once the FAC adjustment to reflect the approach in the 2009 LLCC have been calculated it is necessary to then derive the change in DSACs. In its original report, RGL adjusted DSACs by a proportionate amount. Ofcom has taken a different approach which applied an adjustment to DSAC that was equal to the absolute adjustment made to FAC. The effect of using a absolute adjustment is that the DSAC costs are about £7m higher and so the overcharge is £7m less[65].

5.33 Ofcom has argued for using a absolute approach partly on the basis that if the change in the cost was to the common cost portion of the service FAC would result in no change to DSAC. We do not agree with this. A reduction in common costs would reduce the total 'pool' of common costs being allocated to services. This would result in a change to DSAC as there would be less common cost attracted to it. Therefore, the appropriate range for the DSAC adjustment is likely to be between a minimum of the absolute adjustment to FAC and a maximum of the proportionate adjustment to FAC. We consider that an approach that is 50% absolute and 50% proportionate would be a sensible approach.

5.34 We also note that, if anything, DSAC costs have probably been over-estimated since common costs (as a proportion of overall costs) tend to be over-estimated and costs are considered fixed and common when in fact they are variable to some degree.

[65] Furthermore, using a proportionate methodology results in the DSAC of Main Link in 2007/08 falling below the price charged for the service thereby indicating further overcharging

6 Other issues

6.1 This part of our response covers other issues raised by Ofcom in its draft determination. For ease of reference, we have arranged our comments to match the sections in Ofcom's draft determination.

6.1.1 Legal framework for dispute resolution (Ofcom Section 2)

6.1.2 Summary of the disputes and Ofcom's investigation (Ofcom Section 3)

6.1.3 History of BT's cost orientation obligations (Ofcom Section 4)

6.1.4 BT's regulatory financial reporting obligations and BT's LRIC model (Ofcom Section 5)

6.1.5 Wholesale Ethernet products (Ofcom Section 6)

6.1.6 Services in dispute (Ofcom Section 7)

6.1.7 The question whether BT has satisfactorily demonstrated that its relevant charges are cost orientated (Ofcom Section 10)

6.1.8 Finding of overcharge (Ofcom Section 13)

6.1 Legal framework for dispute resolution

6.2 TalkTalk agrees with Ofcom's conclusion that a dispute had arisen between TalkTalk and BT within the meaning of Section 185 of the Act and that it is appropriate for Ofcom to resolve the dispute under Section 188 of the Act. This means that Ofcom must make a determination resolving the dispute within four months, except in exceptional circumstances.

6.3 Ofcom previously concluded that exceptional circumstances did surround the dispute (due to the link to the PPC appeal and so need to delay analysis / resolution of this dispute pending the judgement in that litigation[66]). However, that judgement in the PPC appeal was made in March 2011 so this constraint clearly no longer applies and it is therefore incumbent on Ofcom to reach a final determination in this dispute as soon as is practically possible. Even assuming Ofcom started no work on this Ethernet dispute until the publication of the PPC judgement then the final determination on this Ethernet dispute should have been in July 2011 (i.e. March 2011 plus 4 months). We are clearly already way beyond that deadline.

6.4 In relation to the present dispute, we agree with Ofcom that the relevant SMP obligation is Condition HH3.1 which requires BT to ensure in relation to BES (and WES) services to ensure that "*each and every charge offered [...] is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed*." This is an essential SMP obligation designed to protect Openreach's customers and ultimately end-users from

[66] Draft determination, §3.12.

excessive charges for BES and WES services. It is just regrettable that Openreach has been found to have largely ignored this obligation for an extended period of time by levying clearly excessive charges on its customers.

6.5 We welcome Ofcom's statement that it expects "*dispute determinations to be read across and followed as appropriate in situations where other parties who were not a party to the dispute, are facing similar questions vis-à-vis one of the parties to the dispute which has been determined*."[67] i.e. that other parties who purchase the WES/BES products in dispute (but were not party to the dispute) are refunded in the same way as the main parties. In this respect, TalkTalk also has an overcharge claim on Openreach by virtue of Ofcom's draft determination in the parallel dispute between Cable & Wireless and BT. TalkTalk intends to write to Openreach as soon as Ofcom has published its final determination in that dispute and request a repayment of the overcharge. Needless to say, we do not expect any delay or prevarication from Openreach and will be referring a dispute to Ofcom without delay if Openreach for some reason fails to acknowledge and repay the overcharge concerned to TalkTalk.

6.2 Summary of the disputes and Ofcom's investigation

6.6 TalkTalk notes that in its submissions on this Ethernet dispute BT chose to repeat its arguments from the PPC dispute and PPC appeal regarding Ofcom's decision to open the dispute for resolution [68]. TalkTalk agrees with the CAT's conclusions[69] in the PPC appeal regarding Ofcom's powers under section 185(1) of the Act and that there is nothing in the Act to suggest that certain disputes should be considered by means of a compliance process rather than by means of the dispute resolution process.

6.7 This ploy is another example of BT's overall strategy in this dispute which again is to throw as many spanners as possible in the wheel to avoid any finding of overcharging. We note plenty of examples in the draft determination where BT has sought blur the picture by a range of different tactics. By way of example, we note that BT sought to claim 'legal litigation privilege' in relation to the work done by its advisers on it proposed DSACs. Ofcom does not disclose whether any information was eventually withheld by BT but we do find it peculiar how DSAC information could be protected by legal privilege given that it must highly unlikely that BT's lawyers prepared this information. We do not believe legal privilege can be claimed in respect of this type of content.

6.8 RGL have noted that their ability to constructively comment on Ofcom's analysis of this dispute has been hampered by lack of disclosure for instance of the cost adjustments resulting from the LLCC. Consequently, TalkTalk (and other CPs) have been disadvantaged. Though we accept that there may be some legitimate confidentiality issues it seems highly implausible that data regarding for example the proportion of 21CN costs that were allocated to particular BES/WES services in 06/07 could possibly be confidential. Assuming that the lack of disclosure was due to BT

[67] Draft determination, §2.6.
[68] Draft determination, §3.17.
[69] Draft determination, §3.18.

confidentiality claims we consider that Ofcom needs to push harder against these claims if its consultation is to be fair and not disadvantageous to the disputing CPs.

6.3 History of BT's cost orientation obligations

6.9 We agree with Ofcom's analysis of the history of BT's cost orientation obligations and that the various statements referred to by Ofcom have established a role for DLRIC and DSAC costs. DLRIC and DSAC costs are useful first order tests that can be used when seeking to analyse whether a regulated operator is compliant with a cost orientation obligation. However, as we explain (above at §§2.6-2.9) a DSAC ceiling on each product is by itself insufficient to ensure that prices are efficient and not excessive and whether ultimately the prices are cost orientated. In particular:

6.9.1 DSAC ceilings permit BT to significantly overall over-recover common costs which is clearly not in consumers' interests nor economically efficient

6.9.2 DSAC ceilings allow, for individual products, far more flexibility and far higher prices that is plausibly likely to be necessary to set an efficient structure of prices

6.10 In respect of this first criteria (overall recovery) it is highly relevant that in the case of the interconnection products, overall recovery was constrained by a the NCC charge control basket and thus arguably a DSAC ceiling was sufficient. In the case of WES/BES there is no charge control basket and so the cost orientation obligation needs to provide a constraint on overall recovery.

6.4 BT's regulatory financial reporting obligations and BT's LRIC model

6.11 It is noteworthy that BT has been subject to a regulatory financial reporting obligations since 1997. The LRIC model that Ofcom is using to produce DLRIC and DSAC figures is the one prepared by BT. TalkTalk notes with some considerable concern that BT is now seeking to change its own DLRIC/DSAC numbers long after the numbers were published. As Ofcom indeed points out, however, BT has not indicated in previous disputes that there was a problem with the way in which the LRIC model was apportioning costs as between services.

6.12 TalkTalk is pleased that Ofcom subsequently rejects BT's rather blatant attempt to 'rewrite history' in order to escape its cost orientation obligation. TalkTalk would simply emphasise the fundamental importance for customers of BT to be able to rely on the published RFS to assess whether charges are cost orientated. It would be clearly unfair and unreasonable to allow BT to make any retrospective changes (unless perhaps they were obvious arithmetic / calculation errors, e.g. volumes errors that could be independently verified).

6.13 Further, we would encourage Ofcom to be particularly wary of accepting any changes that are in BT's favour. BT could, and certainly would have the incentive to, selectively reveal only those errors that work in its favour. It is of little surprise that in this case the numbers they have revealed strongly favour their position by significantly reducing DSACs (see §11.27). Given Ofcom and other parties do not have similar access to BT's RFS and therefore are unable to indentify errors as BT can, allowing BT to suggest changes will introduce bias.

6.5 Wholesale Ethernet products

6.14 TalkTalk agrees with Ofcom's description of the wholesale Ethernet products subject to this dispute. We have nothing to add in this regard.

6.6 Services in dispute

6.15 TalkTalk agrees with Ofcom's analysis as to what BES services (in so far as TalkTalk is concerned) and which time periods should be included within the scope of the dispute. The exclusion of any services (BES or otherwise) or any particular period of time shall not mean that TalkTalk may bring a dispute regarding such services in the future and TalkTalk explicitly reserves the right to do so.

6.7 Has BT satisfactorily demonstrated that charges are cost orientated

6.16 In this section we cover BT's arguments regarding whether it has satisfactorily demonstrated that its charges were cost orientated and the steps it has taken to comply.

6.7.1 BT's arguments as to why it believes that its charges were cost orientated

6.17 BT has raised a number of different arguments in support of its contention that its relevant BES and WES charges were cost orientated in compliance with Condition HH3.1. Again we believe Ofcom has offered a robust analysis of BT's arguments and provided detailed rebuttals where necessary.

6.18 As we explained above (§3.79) the burden is on BT to demonstrate that its charges are compliant. If prices for certain products are higher than FAC then to demonstrate that its prices are economically efficient and therefore compliant with its cost orientation obligation BT would have to provide evidence that:

- 6.18.1 these product(s) were more inelastic
- 6.18.2 and also provide evidence that above FAC pricing on these products was offset by below FAC pricing on other relevant products

6.19 BT has done neither of these and therefore it has not demonstrated that its prices were cost orientated.

6.20 We note that in section 10 (at §10.6*ff*) BT argue that ROCE during the relevant period (06/07 to 09/10) varied between 13.5% and 37.3% and this demonstrates compliance. Ofcom has rightly dismissed this (§10.20). In relation to BT's position on ROCE we make the following observations:

6.20.1 A ROCE analysis is in reality an assessment of whether prices are above FAC (since the costs used in a ROCE analysis are FAC costs). If prices are equal to FAC then the ROCE equals allowed WACC. If prices are above FAC then the ROCE will be greater than allowed WACC (and visa-versa). Therefore, we do not think a ROCE analysis adds anything new above a comparison of prices to FAC – if prices are above FAC then the ROCE is excessive. Accordingly, we would suggest the focus should be on comparing prices to FAC (which is what Ofcom has done elsewhere). It is important in this respect not to confuse 'rate of return regulation' whereby prices are set with reference to actual costs and 'rate of return analysis' where the ROCE is assessed

6.20.2 We agree with Ofcom that the ROCE data provided by BT is largely irrelevant since the figures are based on an aggregated approach and not on a disaggregated service-by-service basis. We have explained elsewhere (§2.8) why individual product tests are necessary as well as product group tests. TalkTalk must presume that BT did not deem it appropriate to provide ROCE figures on a disaggregated basis for the very reason that this would show that return on capital was indeed excessive thus showing that BT had indeed failed to comply with its cost orientation obligation.

6.20.3 In particular, it is noteworthy that BT has included both internal as well as external products. The inclusion of internal masks the vast overcharge on external products. For example, in 07/08 the AISBO ROCE was 31% but was 61% for external services and 25% for internal services (see §7.7 below). The proper analysis must be done on external only as was made clear by the CAT[70].

6.20.4 Even if it was accepted that a highly aggregated approach was in some way relevant, all of the ROCEs are in excess of the allowed WACC (and triple the allowed WACC in one case). BT is permitted to earn returns at WACC not three times WACC

6.21 In relation to BT's argument regarding international benchmarking, TalkTalk believes this information is completely irrelevant. This dispute concerns BT's compliance with its cost orientation obligation, i.e. the relationship between (BT's) costs and prices for the services concerned. It is not an 'international prices orientation' obligation where compliance is assessed based on the relationship between BT's prices and other international comparators' prices

[70] PPC Judgement §338(5)(i): "*First, whether – for the purposes of this particular assessment – BT's internal sales should be taken into account or whether only external sales were relevant. On this question, Mr Myers is obviously right. Given that the repayment ordered by OFCOM applies only to overpayments by the Altnets, it is self-evident that only external sales (and not internal sales within BT) are relevant.*"

6.22 In relation to BT's argument relating to the alleged absence of economic harm, it is again quite apparent that BT has simply raised this to confuse matters. We fully agree with Ofcom's position that the presence of economic harm is not a prerequisite for a finding that charges were not cost orientated. Put simply, Condition HH3.1 would have said so if economic harm was a relevant factor that had to be demonstrated. This was confirmed by the CAT where it said:

> *BT is not permitted to raise prices beyond those that are cost orientated, because this would be likely to cause economic harm: this was established by the anterior finding of SMP made at the time the condition was imposed. Economic harm and breach of the cost orientation obligation are, therefore, two sides of the same coin.*[71]

6.23 Notwithstanding this obvious fact, TalkTalk would argue that it is also rather self-evident that an overcharge causes economic harm. For example, in this case there would have been harm including:

6.23.1 Some of higher WES/BES prices would have been passed through into higher retail prices resulting in:

6.23.1.1 Reduced demand due to higher retail prices

6.23.1.2 Distorted competition due to TalkTalk's weakened competitive position versus BT Retail and Virgin

6.23.1.3 Reduced unbundling and investment geographically restricting competition

6.23.2 If the higher WES/BES prices were not passed through the effects would be:

6.23.2.1 Reduced returns for TalkTalk's shareholders

6.23.2.2 Reduced available funds for investment and lower returns on investment resulting in less investment in unbundling new exchanges, developing new services and acquiring new customers which in turn leads to weakened competition

6.7.2 BT's arguments regarding the steps taken to comply

6.24 TalkTalk has reviewed the arguments presented by BT in relation to the steps it alleges to have taken to comply with its cost orientation obligation.

6.25 In relation to the interaction with Ofcom between 2004 and 2007, TalkTalk believes Ofcom's reasoning is robust. Although Ofcom may have gathered cost and price data from BT, Ofcom never conducted a detailed investigation let alone concluded (or purported to conclude) that BT's charges were or were not cost orientated. In any case, Ofcom could not have reached such a conclusion without (at a very minimum) notifying and/or consulting with CPs. In any case, ultimately it is BT's responsibility to comply with its cost orientation obligation at all times.

6.26 With regard to the Leased Line Charge Control 2009 start price adjustments, TalkTalk believes BT's arguments here are very weak or more likely wholly irrelevant. It is of

[71] CAT PPC Judgement §326

course the case that the adjustment to BES1000 rental price came after the period of investigation in this dispute. What BT appears to be suggesting is that the fact that Ofcom required a reduction in a single BES charge after the period of investigation shows that all other charges were cost orientated during the period of investigation itself. This is highly tenuous and we agree with Ofcom's conclusion that BT could not place any reliance on this event in terms of its obligation to provide charges on a cost orientated basis. We note (with a hint of irony) that BT in this context refers to single charge (BES 1000 rental charge) in stark contradiction to its main argument elsewhere that cost orientation should be assessed on an aggregated basis.

6.27 Finally, in relation to BT's argument around delays to the introduction of price reductions, TalkTalk believes this is completely irrelevant in so far as the question of cost orientation is concerned. Apart from the fact that a 90-day notification period is a reasonably standard obligation on Openreach in several markets, BT cannot blame this for a failure to comply with its cost orientation obligation. BT needs to make sure that it takes into account the need to give 90-days notice when it considers on an ongoing basis whether its charges are cost orientated. Put another way, if BT was concerned that its charges were not cost orientated and that a price reduction was necessary, it should have considered this 90 days earlier and not rely on Ofcom being able to grant a waiver. BT is a large commercial organisation which is or should be capable of actively monitoring its charges relating to cost on an ongoing basis and cannot expect Ofcom to 'bail it out' by waiving a notice period when BT all of a sudden discovers the need for a price reduction.

6.28 In any case, as outlined at §3.128, if BT was concerned about the reliability of its costs it could and should have actively monitored them, expeditiously altered prices to cost outturn and/or erred on the safe side. They chose not to. The fact that they chose not to is no excuse for non-compliance.

6.8 Ofcom's findings of overcharge

6.29 Ofcom's approach to assessing the overcharge is based on only the DSAC test which we consider flawed. Notwithstanding we make the following comments regarding Ofcom's conclusion on overcharge.

6.30 In relation to whether BT's BES charges were cost orientated during the period of investigation, Ofcom has 'provisionally concluded' that:

6.30.1 BT overcharged for BES100 rental in 2006/07, 2007/08, 2008/09 and 2009/10 (§13.28*ff*)

6.30.2 BT overcharged for BES1000 rental in 2006/07, 2007/08, 2008/09 and 2009/10 (§13.37*ff*)

6.30.3 BT overcharged for BES100 connection[xii] services in 2006/07 and 2007/08 (but not in 2008/09) (§13.42*ff*)

6.30.4 BT overcharged for BES1000 connections in 2006/07 (but not in 2007/08, 2008/09 or 2009/10) although Ofcom's position is 'provisionally considers' (§13.50*ff*)

6.31 We agree with this conclusion if the only cost orientation test is assumed to be DSAC. However, as we describe above we do not consider only a DSAC test is not appropriate.

6.32 In respect of BES1000 connection prices were above DSAC for only one year (2006/07). However, the price was over 2.2. times DSAC and 2.8 times FAC. The degree of excessive pricing is significant and thus even though this only occurred in one year it is, in our view, a palpable overcharge. There is no evidence that BT took any steps to address the overcharge by reducing price (see §3.127).

7 Annexes

7.1

7.1 Annex A: Which charges should be cost orientated - disaggregation

7.2 BT argue that it is only the price of products in aggregate that matters (§8.17*ff*) and so cost orientation tests (at say DSAC) should be carried out <u>only</u> at an aggregate level (rather than Ofcom's approach which is only at a disaggregated level).

7.3 We agree entirely with Ofcom's conclusions that the assessment of cost orientation should be made on a disaggregated level. In particular, the rental and connection charge for each BES bandwidth and the main link should each be assessed on their own as to whether they are cost orientated. This interpretation is supported by the following key factors:

7.3.1 The wording of SMP Condition HH3.1 which provides that "*each and every charge*" shall be cost orientated;

7.3.2 The PPC judgment in which the CAT came out strongly in favour of this interpretation of Condition HH3.1; and

7.3.3 The fact that BT itself published DLRIC floors and DSAC ceilings for each service in the RFS.

7.4 Ofcom's interpretation is also consistent with economic efficiency considerations. To illustrate this imagine the following scenario. Prices are set to overall recover FAC costs and so are not, in an aggregate level, excessive. However, individual product prices are misaligned from cost with some prices significantly above FAC and other significantly below FAC. This can, as explained above §3.43*ff* and §3.50*ff*, lead to economic inefficiencies:

7.4.1 For products where the prices are below FAC there may be too little investment/entry in the product and also inefficient entry and competition downstream

7.4.2 For product where prices are above FAC there may be too much entry, investment in the product and a margin squeeze downstream causing ineffective competition

7.4.3 Unless that are significant differences in price elasticities then prices that significantly diverge from FAC are likely to be allocatively inefficient

7.5 Thus clearly a test at an aggregate level only is insufficient to ensure that prices are efficient. (Neither incidentally is a test solely at a product level sufficient – both are needed)

7.6 This can be further illustrated by considering the particular case of WES/BES services. BT have suggested that the compliance test should be only at the aggregated AISBO market level (which includes all BES, WES for internal and external supply) (§9.65). This approach is wholly inappropriate. We explain below why disaggregated tests are necessary.

7.7 Taking first whether to combine internal and external products. If the compliance test aggregates internal and external services then it would in effect allow BT to cross-subsidise from external service to internal services and so distort competition. This is what BT have actually done. BT purchases WES and BES services itself but in very different proportions to external customers. BT have applied high mark-ups on services external customers use more of (e.g. BES) and relatively lower mark-ups on services that it uses itself (i.e. internal 'use' of WES). For instance, in 06/07, 07/08 and 08/09 the revenues and returns they achieved were[xiii]: [[[xiv]]]

AISBO returns/prices

Product	Price % FAC	ROCE
External WES/BES	246%	61%
Other AISBO (i.e. internal)	144%	25%
Average/total	162%	31%

7.8 Only by conducting tests at a level that aggregates internal with external revenues would mask this discrimination. Thus it is essential to test cost orientation at a level that disaggregates internal from external.

7.9 BT have also suggested that BES and WES services are combined. This will allow distortions as between the retail line/broadband markets (which BES serves) and the retail business leased line market (which WES services). It is unclear why one might chose to combine these since there is no/few costs that are shared between the two product sets – BES tends to use backhaul duct and WES access duct.

7.10 BT have suggested combining main link and tails. However, if main link is priced inappropriately it will send distorted make/buy signals in relation to main link / trunk investment and will distort competition as between those operators with trunk networks and those without. Ofcom have also made clear why this is inappropriate (§§8.81-8.86).

7.11 BT have suggested combining connection and rental. However, if connection and rental are not individually cost orientated then it will distort purchasing e.g. incentivising inappropriately long or short contracts.

7.12 In summary it is necessary, in order to achieve economic efficiency, effective competition and confer maximum benefits on consumers, to have ceilings on the price of individual products <u>and</u> to have a (tighter) ceiling on the price/revenue of aggregate sets of products.

7.13 We note that BT has sought to sow confusion in respect of aggregation by introducing a plethora of vague and unsubstantiated arguments (e.g. absence of aggregation across markets, absence of charge control, aggregation in RFS and the nascent state of the market[72]) with the obvious objective of avoiding a finding of overcharging (or indeed reducing the level of overcharge). We believe Ofcom has provided robust and detailed rebuttals of each of BT's argument. However, we make the following additional observations:

7.13.1 In relation to the RFS specifically, we would note that Ofcom has previously consented to BT to produce the RFS with less details in terms of services than that which is contained in the Openreach price list but only on the understanding that BT would still need to show compliance with its cost orientation obligation on an individual service basis if requested to do so (§8.42). It is annoying to note therefore that when BT is requested to provide more detailed service cost information, it is not able to do so. Notably, further disaggregation can only increase the overcharge further. Whatever reasons for failing to do so, it is clear it has at least to some extent hindered Ofcom in carrying out its dispute resolution duties under Section 185 *et seq* of the Act.

7.13.2 It is relevant that Ofcom's approach to applying a test at a disaggregated level is consistent with the PPC judgment. That said, it is worth emphasising that TalkTalk finds the wording of Ofcom's letter to BT of 6 December 2010 slightly peculiar (see §8.75). We do not quite understand why Ofcom felt it necessary at all to write to BT in those terms particularly given the ongoing litigation in the PPC case and the live BES/WES dispute before Ofcom. We agree with Ofcom that the letter was not capable of creating a legitimate expectation on BT's part but it is nonetheless of concern that Ofcom chose to write the letter in the first place thereby allowing BT to advance the argument at all around service aggregation. In any case, clearly a letter written in December 2010 can have no bearing on BT's expectations when it set the prices for WES/BES services in the period April 2006 to July 2009.

[72] Draft Determination, §8.19.

7.2 Annex B: Use of FAC to set charge controls

7.14 Ofcom's approach to setting economically efficient prices in cases of charge controls is to base prices on 'efficient forward looking' costs – in essence the costs that are caused by the provision of the service by an efficient operator[73]. For instance, Ofcom have said:

> *Ofcom's general approach is accordingly, when assessing the "base year costs" of providing the products or services which are subject to an RPI-X price control, to include only efficiently incurred forward-looking costs. A forward-looking cost is one which is causally related to the current and future provision of services. When forward- looking costs are reflected in prices, those prices will give the correct incentives for production, consumption, entry and investment. If sunk costs (such as duct) are included, they are included as an exception to the general rule (see Culham 1 §§27- 31), where necessary to incentivise future investments in sunk assets and where consistent with the stability of the regulatory framework and dynamic efficiency (see Culham 1 §§42-44).*[74]

7.15 In practice Ofcom adopts the following approach for assessing costs for charge controls which accords with this 'general approach':

7.15.1 the allocation of common costs[75] between products is based on the FAC (fully allocated cost) method. The FAC[76] method has two important attributes:

7.15.1.1 ensures that costs (including common costs) are not overall over-recovered

7.15.1.2 allocates common costs 'uniformly' amongst products (according to accounting rules that reflect causality where identifiable and uniform sharing of common costs) (i.e. no Ramsey pricing). FAC can be considered as a 'neutral' allocation of common costs

7.15.2 though the starting point for assessing costs is BT's actual FAC costs, these are adjusted (always downwards) to reflect the level of costs for an efficient operator

7.15.3 uses CCA to value assets (though asset valuation is not pertinent to this dispute)

7.16 We refer to this approach that Ofcom uses to assess costs in charge controls as 'efficient FAC' – i.e. FAC based allocation and efficient operator costs rather than actual costs (and including certain sunk costs[77]).

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[73] This is consistent with the approach required by the Access Directive and other EC recommendations

[74] BT WBA Appeal, Ofcom Defence §48. See also Defence §§1.2, 47, 56

[75] Sunk common costs and/or forward looking common costs

[76] FAC and LRIC+EPMU methodologies give similar results since both draw on similar approaches to attributing total costs

[77] Ofcom's approach includes certain sunk costs (particularly duct) in order to maintain investment incentives (see §7.14 above).

7.17 This approach to deciding what costs to use to set prices is considered by Ofcom to represent a sensible balance between different economic efficiency considerations particularly productive (minimising cost of production), allocative (allocating resources to produce the goods and services which consumers value most) and dynamic efficiency (creating incentives for efficient investment and competition)[78]. It is also considered by Ofcom a reasonably practical and reliable approach since audited FAC numbers are available and FAC is well understood. For example:

> *CCA FAC provides a robust and transparent basis for the regulation of wholesale access charges. It is a well understood concept and has been the cost basis for many previous charge control obligations imposed by Ofcom. Furthermore, CCA FAC uses data which can be reconciled to the RFS, which are published by BT and independently audited.*[79]

[78] See for example BT WBA Appeal WS Culham I §33
[79] Charge control review for LLU and WLR services Statement 7 March 2012 §3.6

7.3 Annex C: Extract from WES/BES contract discussions

Heading	Extract
BES/WES/WEES	WES/WEES/BES
Title	Adjustment to when interest is payable.
Detail	C&W:.....for the period beginning on the date that on which the 2 parties agree BT shall make the repayment and ending on the date BT actually makes payment. Exponential-e Limited: over payment cannot happen due to CP because only BT data is used for calculation see 12.1. Therefore delete phrase. Interest payment shall be from the date of overpayment until date of repayment. Regulatory determination interest (or net present value adjustment) is payable if the regulator determines that it should be. Easynet: No interest available on retrospective price changes
Concern/Comment	C&W; The interest should be payable from the date that the CP actually overpaid and NOT the date that it was agreed such had occurred.
CP Suggested Resolution / Remedy	"C&W: Text to read…..for the period beginning on the date that the CP overpaid BT and ending on the date BT actually makes the re-payment."
Discussion at mtg of 22/11	
Discussion at mtg of 10/12	
Discussion at mtg of 9/1	
Discussion at mtg of 23/1 and conference call of 31/1	12.3 to adjusted to take account of a new Interest Rate definition - see response above. Openreach researching the issue around retrospection and also C&W's issue about date that the refund applies from.
Subsequent responses / comments from Openreach (incl response to BI comments)	No additional comments to those already made. Openreach reject point made by C&W relating to retrospection.
Discussion/response relating to CP priority listing on 26/3 and updated for mtg of 9/4 and 23/4	No additional comments to those already made. Openreach reject point made by C&W relating to retrospection.

7.4 End notes

[i] When we refer to WES/BES we include (in line with Ofcom's approach):
• external services only (i.e. not including internal)
• BES100 rental, BES100 connection, BES1000 rental, BES1000 connection, WES10 rental, WES100 rental, WES1000 rental and main link
• in each of 06/07, 07/08 and 08/09
• we exclude 09/10 (for illustration purposes only) in order to simplify matters since in 2009/10 only part of the year is relevant and only certain services are relevant

This group of services is used to illustrate average/typical levels of costs e.g. DSAC of FAC. Within this group DSAC varies from [5% less than FAC to [302% more than FAC.

[ii] The DSAC methodology in essence calculates of the cost of a product as:
• LRIC of the product
• plus X% of 'group' and 'network' common costs

where:
• X% is the product LRIC as % of total group LRICs
• the 'group' common costs are costs common across certain services
• the 'network' common costs are costs common across different groups

See Draft Determination §A6.2

[iii] §9.55 mentions Ramsey pricing (in the context of differential recovery of common costs from different markets. It says: "*In general, it would be more economically efficient for the firm to put relatively higher mark-ups (i.e. potentially greater than those embodied by a FAC regime) on services where (market) demand is more inelastic. Such an approach minimises the distortion of consumer choices because a relatively larger proportion of common costs is recovered from consumers who are relatively less sensitive to higher prices than those where market demand is more elastic.*"

See also §11.39

[iv] In a charge control prices are set based on estimated future costs and a glidepath. Once prices are set they are fixed (except with respect to RPI). During a charge control reductions in costs are not passed through in lower prices. In subsequent charge controls reductions in prices may be (gradually) passed through. Therefore, reductions in costs flow through into added profit for a number of years.

[v] It may be considered that equivalence of input (EOI) whereby BT's downstream operations purchase the same wholesale product may avoid the risk of margin squeeze. However, we do not consider this to be the case since the wholesale price that BT's downstream operations 'pay' is merely notional since there is no real cash transaction / flow and BT is likely to price its retail services based on its costs and not the internal wholesale prices. In any case EOI does not apply to backhaul products (such as BES).

[vi] We note, as a more general point, that given that the genuine 'internal price' is efficient forward looking' costs the best way of guarding against price discrimination (and margin squeeze) and so ensuring effective competition is to set all external prices to equal efficient forward looking costs (except possibly in cases where BT purchase products in the same proportions as competitors). It is telling in this case that in the case of WESS/BES services BT have relatively marked up services used externally – this has allowed BT to show a lower return across AISBO than the return for external customers

[vii] we note that using the elasticity at the wholesale level would somewhat defeat the purpose of regulation. Since these are products where BT has SMP wholesale customers have little or no choice but to buy from BT implying that they are relatively inelastic. If Ramsey prices were set on the basis of these low elasticities then more common cost would be allocated to these regulated products and the prices would be higher and excessive.

[viii] Assumptions used produce Ramsey-price equal to DSAC (i.e. FAC+100%):
• BES1000 rental 2% of volumes of total relevant services
• common costs 60% of total costs (at LRIC +EPMU prices). Based on analysis of RFS which is consistent with other data
• BES1000 rental elasticity $\varepsilon = -0.09$
• Other relevant services elasticity $\varepsilon = -0.25$
• linear demand functions

[ix] Assumptions used produce Ramsey-price equal to DSAC (i.e. FAC+100%):
• WES/BES 10% of volumes of total relevant services
• common costs 60% of total costs (at LRIC +EPMU prices). Based on analysis of RFS which is consistent with other data
• external WES/BES elasticity $\varepsilon = -0.07$
• Other relevant services elasticity $\varepsilon = -0.25$
• linear demand functions

[x] Ofcom has in effect toyed with applying a constraint on overall recovery since such a constraint is implicit in use of combinatorial tests. A combinatorial test on a group of all products would result in common costs being recovered (but not over-recovered). However, Ofcom has not pursued using combinatorial tests for practicality reasons. Though combinatorial tests may be impractical this should not divert Ofcom from continuing to apply the no overall cost-recovery principle that underlies a combinatorial test.

[xi] This analysis was conducted from the RFS for 06/07, 07/08 and 08/09

The costs do not reflect Ofcom's view of costs which are lower than those in RFS. In particular, the RFS overstates costs (e.g. uses CCA valuation not RAV, excludes adjustments to TISBO and AISBO numbers that resulted from subsequent disputes).

The TISBO trunk, ECC, support price/ROCE data was taken from Ofcom PPC Determination (Table 7.3) and CAT PPC Judgement (§126).

Other AISBO derived as total RFS reported AISBO less external WES/BES. The RFS reported costs are higher than genuine costs (as reflected in adjustments made in this dispute). Thus the 'Other AISBO' price % FAC and ROCE are underestimated. More generally genuine costs were lower than in RFS (e.g. RAV not CCA) and so price % FAC and ROCE for all services are underestimated

There will be some services in WLA, analogue WLR, PPC and NCC that are not charge controlled (e.g. SFI, TRC, enhanced care in WLA) however these are likely to be small.

Ideally this analysis would be conducted for external services only however this is not possible given that MCE data is not available separately for external and internal. Given how BT uses flexibility to extract higher returns on external services in aggregate then if the analysis was conducted for external only we would expect the excessive returns to be even higher

[xii] We note that Ofcom does not appear to have challenged BT on the point as to why the costs of BES100 Connection has increased almost ten-fold over the period of investigation (from a total external DSAC of £3.9million in 2006/07 to £30.7million in 2009/10 whilst revenue has total external revenue has fallen from £8.7 million to £2.4 million in the same period).

[xiii] 'External WES/BES' comprises external BES100 rental, BES100 connection, BES1000 rental, BES1000 connection, WES10 rental, WES100 rental, WES1000 rental and main link.

Other AISBO comprises predominantly 'internal' supply. Other AISBO derived as total RFS reported AISBO less external WES/BES. The RFS reported costs are higher than genuine costs (as reflected in adjustments made in this dispute). Thus the 'Other AISBO' price % FAC and ROCE are underestimated.

[xiv] Of course what this data shows is that BT has set prices in a way that favoured 'internal' customers over external by marking up the products that external customers purchase relatively more and marking down (relatively) products that are used internally relatively more.