



# Wholesale ISDN30 price control

Openreach response to the Ofcom further consultation  
dated 22 December 2011

**3 February 2012**

**NON-CONFIDENTIAL VERSION**

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This response is provided on behalf of British Telecommunications plc (“BT”) by Openreach, a line of business within BT. References to Openreach should also be read as being to BT, where appropriate.

## 1 Executive Summary

1. ISDN30 is widely perceived as a legacy service that is in decline. In Ofcom's consultation entitled "*Wholesale ISDN30 price control – further consultation*" published on 22 December 2011 ("second consultation"), it now proposes price reductions to the wholesale ISDN30 service over two years. Openreach would prefer that Ofcom carry out the price reductions over a three year period, thereby reducing the risk of unintended consequences through shocks to demand and/or industry. It is important to note that this is the first time that Ofcom proposes to apply a charge control to this declining, legacy service and that Ofcom has already recognised the potential for unintended consequences to follow a price reduction.
2. In Ofcom's consultation "*Price controls for wholesale ISDN30 services*" published on 1 April 2011 ("first consultation"), Ofcom sought to balance the diverse views of relevant stakeholders, and proposed measures that sought to:
  - a) take account of the depreciated state of ISDN30 assets by setting a control based on an adjustment of BT's costs to represent those of a hypothetical ongoing network
  - b) avoid potential shocks to demand that might result from too great a step-change in regulation. In particular :
    - an additional cost orientation obligation would be disproportionate and inappropriate
    - insofar as a smooth glide path without step changes is crucial in the context of significant demand uncertainties (such as in the case of ISDN30), the imposition of a start-price adjustment could result in immediate shocks to demand and would thus be inappropriate and disproportionate.
3. These proposals went some way to addressing Openreach's concerns about unintended consequences, particularly by acknowledging the uncertainty surrounding the development of demand both for these services and for alternatives. In particular, Openreach is increasingly facing scarcity of resources to cater for new demand. For each new order, Openreach struggles to source network components as equipment has passed its last buy date, and there are increasing costs associated with lifting and shifting equipment (which is not always possible) around the network.
4. Should Ofcom choose to increase its volume assessments prior to reaching its final decision this, combined with a two year control, would have the effect of increasing the risk of unintended consequences. In such circumstances Openreach would encourage Ofcom to consider extending the charge control by an additional year to strike the right balance by ensuring its final proposals continue to take into account the risk of unintended consequences.
5. Finally, Openreach continues to disagree with a number of the costs and parameters used by Ofcom to model ISDN30 costs. These costs and parameters are common to the

controls for LLU and WLR and, as laid out in detail in Openreach's response<sup>1</sup> to Ofcom's "Charge control review for LLU and WLR services" published on 31 March 2011, and updated on 18 May 2011. Openreach particularly disagrees with the following assumptions:

- i) Ofcom's duct valuation, which understates the value of Openreach's duct assets
- ii) Ofcom's estimate of inflation, which is too low
- iii) Ofcom's estimate of efficiency gains, which is too high
- iv) Ofcom exclusion of pension deficit repair payments from the costs to be recovered from regulated charges
- v) while we agree that ISDN30 is a business-only service that is subject to greater systematic risk than copper lines and that it is therefore more appropriate to apply the "Rest of BT" rate of Weighted Average Cost of Capital ("WACC") than the "Copper Access" WACC rate,<sup>2</sup> Openreach considers that there is strong evidence to suggest that both of these rates of WACC are understated and therefore inappropriate with respect to ISDN30.

Openreach set out its comments on these points in detail in its response to the first LLU and WLR consultation. Openreach refers Ofcom back to those comments, and requests Ofcom to address the points raised in its final statement.

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<sup>1</sup> Openreach, *Charge control review for LLU and WLR services — Openreach response to the Ofcom consultation dated 31 March 2011*, July 2011.

<sup>2</sup> Openreach, *Price controls for wholesale ISDN30 services — Openreach response to the Ofcom consultation dated 1 April 2011*, July 2011.

## 2 Comments on Ofcom's proposals

6. Ofcom should consider maintaining the charge control period at its normal full three year duration. This would result in less steep price reductions over a longer time period, thereby promoting productive efficiency and reducing the risk of unintended consequences from the charge control.

### 2.1 Duration of charge control

7. Ofcom has set out its proposals for the ISDN30 charge control to apply for a period of just 23 months. That is, the ISDN30 charge control is expected to commence on 1 May 2012 but Ofcom still proposes that it ends on 31 March 2014. Ofcom's main reasons for the shorter time period appears to be that it will encourage allocative efficiency and align the ISDN30 controls with those for WLR/LLU.
8. Reducing the duration tends to undermine the key incentive properties of the charge control framework and for this reason short durations should be avoided. The European framework guideline is that charge controls should be reviewed every three years. As a general principle Openreach believes that charge controls of shorter duration than three years are inappropriate, especially when a charge control is being introduced for the first time.
9. Moreover, Ofcom needs to consider the balance of setting prices close to cost (for allocative efficiency); to encourage cost minimisation (for productive efficiency) and to provide the right incentives to invest (for dynamic efficiency).
10. Openreach believes that there is a risk that it will not be able to meet, or will incur high costs to meet, any new demand for ISDN30. Openreach has set out in Annex A the practical restrictions it faces in sourcing new equipment, and the costs that it would incur to re-engineer or lift and shift equipment around the network. Such costs to cater for new demand would be inefficiently incurred by Openreach, particularly given the anticipated movement to IP alternatives.
11. The level of the ISDN30 charge(s) will partly determine the level of demand, and lowering the price too quickly will tend to encourage further take-up, which could lead to inefficient investment by Openreach in an obsolete technology and increase barriers to investment in alternate technologies.
12. Openreach considers that a longer duration for the charge control will tend to encourage productive efficiency, and may be more dynamically efficiency. Therefore, while Ofcom's proposal to shorten the time period for the ISDN30 charge control may encourage allocative efficiency, Ofcom must also consider the extent to which this has an adverse impact on productive and dynamic efficiencies.
13. Alignment with the LLU and WLR charge control appears sensible, as the charge controls are based on the same underlying cost. Furthermore, Ofcom's assumptions about the required level of efficiency, level of inflation etc have been assessed via the consultation process for the LLU and WLR charge controls and reflected in the ISDN30 figures.
14. It is arguable whether the benefit of aligning the ISDN30 control with those of WLR and LLU outweighs the adverse impact that would result from diluting the incentive

properties of the proposed ISDN30 charge control. While Openreach recognises the practical issues and delay that might result from extending the control to the normal three year duration we would encourage Ofcom to further explore this possibility.

## 2.2 Glidepath options

15. Ofcom sets out three options to shorten the duration of the charge control. The options are:
- Option 1: maintain the RPI-10.75% glidepath from the first consultation, leaving prices above FAC at the end of the control period
  - Option 2: implement a one-off price adjustment to reduce prices to the level in the second year of the three year glidepath set out in the first consultation, and then maintain that glidepath to FAC at the end of the control period
  - Option 3: set prices on a two year glidepath to FAC at the end of the control period, by increasing the rate of change to RPI-14.57% per annum.
16. Openreach encourages Ofcom to consider an additional option of extending the charge control into 2015 for the reasons set out above. Should Ofcom not choose to do this, then Openreach would prefer option 1 as, of the three options presented, this would carry the least risk of unintended consequences.
17. Openreach does not agree that Option 2 is proportionate or reasonable, given that it would result in the largest shock to prices and have the highest risk of unintended consequences and inefficiency.
18. Ofcom considers that the proposal to decrease costs over a shorter duration strikes the right balance of maintaining benefits of the price control to end-users while ensuring that industry is able to adjust to the change adequately because the end cost is slightly higher in the second consultation compared with the first consultation.<sup>3</sup> However, Ofcom has also noted that volumes have fallen by a slightly smaller amount than it had projected in the first consultation.<sup>4</sup> As a result, should Ofcom increase its volume assessments prior to reaching its final decision Openreach would ask Ofcom to continue to take a prudent approach and consider extending the control by an additional year. Openreach is prepared, if required, to urgently assist Ofcom should it need more information in order to extend the control to 2015 and minimise any delay in setting a three year control.

## 2.3 Other matters

19. The Retail Price Index (“RPI”) statistic that Ofcom proposes to use for calculating the ISDN30 charge controls is unclear. The legal instrument defines RPI to be the statistic in the period of twelve months ending on 31 December immediately before the beginning of a relevant year,<sup>5</sup> however the main body of the consultation refers to the use of the October statistic.<sup>6</sup> Openreach requests that Ofcom amends the legal instrument to use the

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<sup>3</sup> Ofcom second consultation, paragraph 2.15.

<sup>4</sup> Ofcom second consultation, paragraph 4.15.

<sup>5</sup> See Ofcom second consultation, Condition AAA(IS)4A.15v on page 57 and footnote 63 on page 54.

<sup>6</sup> Ofcom second consultation, paragraph 2.47.

October statistic, as this will maintain consistency with the inflation assumption use for the glidepath for the LLU and WLR controls.

20. Ofcom also makes reference to the changes in the cost data that Openreach has supplied.<sup>7</sup> We appreciate that the changing data has frustrated Ofcom. However, the absence of a previously reported Distributed Stand Alone Cost (“DSAC”) meant that BT estimated these figures for the purpose of informing Ofcom’s analysis and the necessary changes that were made highlight the complexity of the allocations in the Regulatory Financial Statement and calculation of measures such as DSAC.

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<sup>7</sup> See for example Ofcom second consultation, paragraph 1.9.

### 3 Answers to the Ofcom questions

21. This section provides Openreach's responses to the questions raised in the Ofcom further consultation.

Q2.1 Do you agree that we should adopt a price control based on a 2 year period and align the prices of ISDN30 core services with their underlying costs of provision?

22. Openreach would prefer that Ofcom carry out the price reductions over a three year period for the reasons outlined in section 2 of this response.

Q2.2 Do you agree that in this case we should adopt Option 3 should be preferred to Option 2?

23. Openreach would urge Ofcom to consider an additional option of extending the charge control into 2015. Should Ofcom not choose to do this, then Openreach would prefer option 1 as, of the three options presented, this would carry the least risk of unintended consequences - please see explanation in section 2.2.

Q4.1: Do you agree with our assessment that there has been no material change in the wholesale ISDN30 exchange lines market since our determination that Openreach had SMP in the MR statement? If not, please explain why.

24. For the purposes of introducing the ISDN30 charge controls, Openreach agrees with Ofcom's assessment that there has been no material change in the ISDN30 market since Ofcom's review in 2010.

## **Annex A Overview of ISDN30 component availability**

25. The table below summaries the practical difficulties that Openreach will have fulfilling orders and maintaining its current ISDN30 base. Should there be a significant increase in demand, any one of the five network components shown below will be subject to “stock-outs” and increased costs due to the requirement to recover equipment that is not in use in one location, refurbish it, and then install it in another location.
26. Where new equipment is required to be placed in the network (rather than BT engineers lifting and shifting equipment around in the network), the lead time for the contractors to install the equipment is 3 to 4 months if the kit can be found.

### **Table 1 ISDN30 component availability**

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