



BT's response to Ofcom's consultation on Business Connectivity Market Review: update on the proposed leased lines charge controls

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NON CONFIDENTIAL VERSION

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1. Executive summary

1. BT is glad to have this opportunity to comment on Ofcom's re-consultation on the Leased Line Charge Control, which is important to enable BT to deal with the challenges of meeting growing demand through further investment and innovation whilst, at the same time, continuing to deliver service improvements for Ethernet services. For TI services, the challenge is to maintain the legacy platforms whilst encouraging migration, and we are particularly encouraged that Ofcom has made positive changes to the TI charge control, where BT believes Ofcom had significantly under-stated BT's costs.
2. This response is focussed on the specific proposals put forward in Ofcom's document entitled "Business Connectivity Market Review: update on the proposed leased lines charge controls" dated 13 November 2015 ("the LLCC2 Consultation"). However, those proposals are significantly impacted by the separate proposals set out in the Cost Attribution Review ("CAR") consultation paper. As such, the key arguments in BT's CAR responses of 13 August 2015 and 15 December 2015 are relevant to this response, in particular that BT's existing methodology for the allocation of overheads is appropriate by reference to the Regulatory Accounting Principles, and should therefore remain.
3. Ofcom's modifications to its detailed modelling address some of the concerns BT raised in its August response, and BT supports in particular:
 - modelling common costs separately;
 - adopting dynamic CVEs and AVEs to take account of changes to the cost mix;
 - the separate modelling of TI assets; and
 - the approach to asset disposals that prevents fixed common costs being reduced.
4. Nonetheless BT is disappointed that Ofcom has not appropriately addressed key concerns BT raised (and detailed evidence provided) in response to Ofcom's June LLCC proposals, in particular,
 - the unwarranted level of start charge adjustments ("SCA");
 - the unduly high efficiency assumptions;
 - the unrealistic asset disposals and accommodation reuse assumptions for TI;
 - the error in its calculations of the Quality of Service ("QoS") uplift and the understated Cost Volume Elasticity of access fibre costs for Ethernet; and lastly,
 - the improbably low Dark Fibre volume assumptions.
5. However, there are some remaining issues with the proposed modelling, including:
 - The proposed efficiency factors are too high, and we have provided evidence from many sources that efficiency should be set at no more than 1.5% for TI and 3.5% for Ethernet.
 - The asset disposals approach for TI should be moderated, as assets cannot in general be sold as suggested. The approach should be limited to the extent that assets could be re-used or re-allocated to other services. BT suggests that only one-half of the modelled "disposal" of duct and fibre should be considered to be available for reuse.
 - The Cost Volume Elasticity ("CVE") for accommodation costs and transmission equipment costs should be lowered to 0.13. This reflects the potential rationalisation of the SDH network attributable to TI volume decline.
 - The Ethernet Access Fibre Asset Volume Elasticity ("AVE") is too low and should be increased to 0.8. The LRIC-model based AVE assumes the Access Fibre network is

completely pre-provided whereas in reality the footprint is expanding, so investment is needed to grow the footprint as volumes increase.

- The cost uplift required to meet our current Ethernet service improvement plans is £30m higher in the final year than estimated by Ofcom. As we have previously evidenced, Ofcom has incorrectly modelled the inclusion of these costs and this needs to be corrected to allow Openreach to fully recover these costs, as we understand is Ofcom's intention. Separately, we now believe further expenditure will be required, over and above this uplift, to meet the proposed Ethernet MSLs over the charge control period. We are currently finalising our detailed evidence on this and will be making an additional submission to Ofcom shortly after this response.
6. In its new Consultation, Ofcom has changed the criteria it applied to making SCA from its June Consultation. Unlike the tests Ofcom applied in its June Consultation, which we would stress we did not accept, this "revised approach" is lacking in transparency and does not set out clear criteria for when such SCAs should be made. It is not therefore an approach that is consistent with proper regulatory practice.
 7. Given this, BT considers there are good grounds to remove the SCA entirely for TI and Ethernet services:
 - For TI, Ofcom has struck the wrong balance between the damage SCA will do to incentives to migrate and the potential benefits to end customers and competition, of bringing pricing into line with costs more quickly than a glide path. TI is a declining legacy product and it is highly unlikely that the potential benefits cited by Ofcom will materialise while the dis-benefits of sending the wrong migration signals are far more likely and should be avoided.
 - For Ethernet, Ofcom has struck the wrong balance between the damage SCA will do to investment incentives and the potential benefits to end customers and competition, of bringing pricing into line with costs more quickly than a glide path.
 8. Should Ofcom continue to propose SCA in the final statement, despite it undermining the incentive properties of a CPI-X type control, introducing regulatory uncertainty, discouraging investment and undermining efficient migration signals, the SCA reduction should be no more than 1.8% and 0.65% for Ethernet and TI services respectively. These figures represent adjustments for errors only, as outlined in our response to the June LLCC consultation.
 9. Ofcom's proposals in this consultation are to exclude costs for the base year that are already excluded in CAR2: it must modify its proposals to avoid such a 'double' exclusion of costs in the charge control. Moreover, restructuring costs should be included as allowable costs as suggested in the CAR2; these costs are necessary for BT to be able to make the efficiency savings assumed by Ofcom.
 10. All the evidence points to a TI control towards the top of the consultation range of CPI + 2.5% per annum. A small increase in prices would incentivise migration away from legacy services. The base case proposals, whilst much improved, still require a 15% reduction in prices over the course of the three year charge control, and set the wrong economic incentives for migration in this legacy market. Similarly, the evidence in respect of Ethernet indicates an Ethernet control at the top of the range of CPI-6.5%.

2. Response to consultation questions

Question 3.1: Do you agree with our proposals for further cost adjustments relating to BT's 2013/14 and 2014/15 cost data? If not, what alternative would you propose and why?

11. Section 3 of the LLCC2 Consultation set out Ofcom's proposals for further adjustments as follows:
- To use BT's 2014/15 RFS as the starting point for the base year costs in the 2016 LLCC Statement (paragraphs 3.5-3.6 and Table 3.1).
 - Base year adjustments to reflect the CAR, in relation to (paragraphs 3.9-3.14 and Table 3.2):
 - a. Certain General Overheads
 - b. Property and electricity
 - c. Duct
 - d. Fibre
 - e. Openreach and TSO software
 - f. Vacant space
 - Base year adjustments relating to BT's 2014/15 cost data, in relation to (paragraphs 3.15-3.27):
 - g. EE acquisition costs
 - h. Property rationalisation costs

We set out our comments on each of the above in turn below.

To use BT's 2014/15 RFS as the starting point for the base year costs in the 2016 LLCC Statement (paragraphs 3.5-3.6 and Table 3.1)

12. In line with the June 2015 LLCC Consultation, Ofcom proposes to use BT's 2014/15 RFS as the starting point for the base year costs in the 2016 LLCC Statement. BT has no further comment on the additional cost adjustments proposed for 2014/15 base year data, except that given that Ofcom is proposing to exclude a proportion of these costs in its CAR2 proposals (specifically to adjust corporate overhead costs), Ofcom must ensure there is no duplication of the cost adjustments proposed.
13. A number of cost adjustments proposed by Ofcom to 13/14 base year data are already reflected in the 14/15 Regulatory Financial Statements (RFS). As a result, when Ofcom updates its charge control model for 2014/15 costs some of the adjustments made for the consultation will not be required for the final statement. It is important to note that, even when adjustment is still required, the magnitude of the adjustment may change.
14. Table 1 below shows a list of the cost adjustments applied in the LLCC2 Consultation ("2013/14 base year data") and whether the adjustment is still required for the final LLCC statement ("2014/15 RFS costs"). If it is, additional comments are provided explaining why the adjustment might be different to that proposed in the LLCC2 Consultation (2013/14 RFS costs).

Table 1 - Adjustments to base year costs in 2014/15 (based on Table 3.1, “Update on the proposed leased line charge controls” in the LLCC2 Consultation)

Proposed Adjustment to 13/14 base year data	Adjustment required for Ethernet in 14/15?	Adjustment required for TI in 14/15?
Access cards	No – adjustment included within RFS in 14/15	No – adjustment included within RFS in 14/15
June 2015 CAR - Errors	No – one off errors in 13/14	No – one off errors in 13/14
June 2015 CAR– General Overheads	Yes – but needs updating for results of CAR2 consultation	Yes – but needs updating for results of CAR2 consultation
RAV	No – adjustment included within RFS in 14/15	No – adjustment included within RFS in 14/15
Cumulo	No – adjustment included within RFS in 14/15	No – adjustment included within RFS in 14/15
Transmission Equipment	Yes – but magnitude will decrease	N/A
Restructuring Costs	Yes – but BT disagrees with cost exclusion	Yes – but BT disagrees with cost exclusion
Quality of Service resource uplift	Yes – but BT disagrees with Ofcom calculation	N/A
SLG Payments	Yes	N/A
Credit Notes	N/A	No – only an issue in 13/14
TI Volumes	N/A	No – only an issue in 13/14

Note – “N/A” in the Table above means the cost adjustment is not relevant for that particular market

Base year adjustments to reflect the CAR (paragraphs 3.9-3.14 and Table 3.2):

15. BT’s response to the November 2015 CAR Consultation of 15 December 2015, set out BT’s comments in relation to Ofcom’s proposals relating to:
 - a. Certain General Overheads
 - b. Property and electricity
 - c. Duct
 - d. Fibre
 - e. Openreach and TSO software
 - f. Vacant space

Base year adjustments relating to BT’s 2014/15 cost data, in relation to EE acquisition and property rationalisation costs (paragraphs 3.15-3.27)

16. BT’s has no comments on the two cost adjustments except to note Ofcom is proposing to exclude a proportion of these costs in its CAR2 proposals (specifically the proposals to adjust corporate overhead costs) Ofcom must perform the adjustment net of the CAR2 proposals to ensure there is no duplication of the cost adjustment.
17. BT makes the following points about restricting costs and Quality of Service costs.

Restructuring costs

18. In the June 2015 LLCC Consultation Ofcom proposed that restructuring costs are to be excluded from the base year in the charge control calculation. In the August 2015 LLCC Response, BT

explained that we consider these costs should not be excluded from the base year, as they represent necessary costs to ensure future efficiencies are realised. Without restructuring costs, the efficiency levels Ofcom proposes cannot be met, and BT disagrees that these costs 'do not appear to be forward looking' as stated by Ofcom.¹

19. Only restructuring costs relating to BT TSO, Openreach, BT Wholesale and BT Group were allocated to BCMR services in the RFS, as these are legitimate costs of transforming these businesses. Any costs relating to downstream parts of BT Group (specifically BT Business, BT Consumer and BT Global Services) are allocated to retail residual services within the RFS.
20. Ofcom's proposed treatment of these costs is inconsistent with the CAR2 proposals. As part of the CAR2 proposals, Ofcom proposed alternative methodologies to allocate these costs to BCMR markets.
21. Moreover, as part of the CAR2 proposals, Ofcom proposed alternative methodologies for general overheads, which reallocate costs from regulated to unregulated services. Subsequently, a proportion of restructuring costs has already been removed in the CAR2 adjustment from the base year costs. Ofcom is now proposing to separately remove all of the restructuring costs allocated to business connectivity services from the base year costs. It appears therefore that, by not considering the proportion of restructuring costs already removed from the base year under the CAR2 proposals, Ofcom is effectively removing part of the restructuring costs twice. This would result in an inappropriate double exclusion of the same costs. This is inconsistent with Ofcom's stated intent to exclude restructuring costs only once.² It is imperative that Ofcom's adjustment removes any 'double count' of the CAR2 adjustment for restructuring costs.

Quality of Service Costs

22. We are surprised and disappointed that Ofcom does not propose to correct its modelling of the QoS uplift as BT proposed in its August 2015 LLCC Response.³ Without this correction, Openreach will not be able to fully recover the additional resources recruited in respect of the Ethernet service recovery plan, contrary to Ofcom's stated intention. A detailed explanation of the modelling correction Ofcom needs to make can be found in BT's August 2015 LLCC Response.⁴
23. Separately, we now believe further expenditure will be required, over and above this uplift, to meet the proposed Ethernet MSLs over the charge control period. We are currently finalising our detailed evidence on this and will be making an additional submission to Ofcom shortly after this response.

¹ A7.56, Annexes to the June 2015 LLCC consultation.

² A7.57, Annexes to the June 2015 LLCC Consultation.

³ Paragraphs 171-174, BT's response to Ofcom's June 2015 LLCC Consultation, 14 August 2015.

⁴ Paragraphs 186-191, BT's response to Ofcom's June 2015 LLCC Consultation, 14 August 2015.

Question 4.1: Do you agree with our approach and proposal to revise the efficiency range for TI services? If not, what alternative would you propose and why?

Proposed efficiency ranges

24. In the LLCC2 Consultation, Ofcom proposes to consult on a revised efficiency range for TI services of 2-6% per annum. Ofcom is not proposing any change to the efficiency range for Ethernet services (paragraph 4.19).
25. BT welcomes Ofcom's reassessment of the potential for efficiency savings arising from TI services, and its proposal to reduce the proposed efficiency range down to 2%-6% from 4%-7%. This is based on new analysis carried out on TSO costs that can be attributed to TI services. This goes some way to address the issues we raised in relation to the use of BT's PVEO analysis produced for internal management purposes. The analysis shows that expected efficiency gains from TI services are limited to 1.5% to 2%, and certainly not above the 2% in Ofcom's revised range. This is consistent with the evidence BT previously submitted in the August response and is supported by the additional evidence that we have submitted to Ofcom.
26. The LLCC2 Consultation does not consider the additional PVEO analysis that Ofcom has requested from BT which will have an impact on the proposed efficiency range for Ethernet services. In particular, Ofcom's June Consultation stated that efficiency "is stated with reference to the overall reduction in cash costs, i.e. it takes into account any additional costs incurred in delivering those efficiencies". Indeed, Ofcom's previous charge control decisions took explicit account of the costs of implementing efficiency-saving programmes. The use of PVEOs requires explicit consideration of these costs, and BT's response to Ofcom's s135 information requests ("October analysis") addresses this, and should be taken into account in reassessing the evidence on efficiency savings from Ethernet services. This updated analysis shows that a reasonable range for potential savings between 2015/16 to 2018/19 is 3%-4%, and when other evidence is taken into account, the 2%-5% range with a central estimate of 3.5% we suggested in our August 2015 response, is more appropriate.
27. Ofcom reiterates its use of different sources of data when considering an appropriate efficiency assumption for TI and Ethernet services. BT's August response addressed the relative merits of each of these in detail, and also provided additional sources of evidence on efficiency (also referred to Ofcom as equivalent to total factor productivity in the context of its charge control modelling) which serve as a useful check on Ofcom's assumptions.

Efficiency assumption for TI services

28. BT welcomes Ofcom's proposal to revise the efficiency range for TI services down to 2% to 6%. This goes some way to address a number of points raised by BT in relation to the treatment of legacy services. Ofcom notes that it is still considering the responses received on efficiency and BT's revised data provided since the August submissions. BT would urge Ofcom to reduce the efficiency target from the base case of 5% for TI services to the bottom of the range, as the evidence supports this.
29. As set out in the June Consultation, Ofcom's approach to assessing TI efficiency using PVEO data is to consider the efficiencies from the different divisions (BT TSO, BT Wholesale, and Openreach), and multiply each of those by their respective contributions to TI costs. Given the weighting of BT TSO costs in TI services, BT's October analysis shows how BT TSO costs flow through into TI services in the RFS.
30. Using the data that BT provided previously, there is a marked difference between total BT TSO (excluding overseas) efficiency and the efficiencies that are relevant to TI services. In particular, given that accommodation costs account for the majority of TI operating costs, it is only correct to identify whether savings are expected from this category of costs from the BT TSO PVEOs. Furthermore, part of the accommodation costs also relate to electricity, whereby cost savings are already addressed through the combination of Ofcom's assumptions on CVEs and input price changes and therefore should not be double-counted here.

31. In addition, BT has calculated the efficiencies net of the costs required to deliver these efficiency savings. Notwithstanding our reservations regarding the use of PVEOs as the main input for setting charge controls, BT's October analysis set out a number of adjustments that are required in order to account for the different expectations of efficiency savings for different network operations and potentially the double-counting of efficiencies across lines of business. This shows that the contribution of BT TSO cost savings to TI services is a fraction of what is expected of the division as a whole. This disaggregated approach reflects the cost mix in the TI market and supports BT's August response that there is only a small contribution of BT TSO cost savings to TI services and that there is a slowing down in the rate of cost reduction that is expected across the divisions.

Table 2 Net efficiency savings based on analysis of PVEOs

	2014/15	2015/16	2016/17	2017/18	Average
<i>Total TSO (excluding overseas⁵)</i>	✂	✂	✂ ⁶	✂	✂
<i>Adjusting for leaver costs & CTC payments⁷</i>	✂	✂	✂	✂	✂
<i>Relevant TSO costs flowing into TI</i>	✂	✂	✂	✂	1.5%
<i>BT Wholesale</i>	✂ ⁸	✂	✂ ⁹	✂	✂

32. The data above shows that the weighted average of TI efficiency should be between 1% and 2% using the approach Ofcom set out in the June Consultation. Given that BT TSO accounts for a greater proportion of TI costs, we would expect TI efficiency to be close to 1.5%.
33. This result is supported by the additional evidence that BT provided as part of its August response, summarised in the table 3 below. The notion of a frontier shift is that it is necessarily a long term one, and therefore it is appropriate for the wide-range of academic studies to consider historic data going back a number of years. The fact that they are not based on the most up-to-date data does not render them irrelevant for the consideration of the long term productivity trend.
34. In considering the legacy nature of TI services, where at the retail level Ofcom is proposing deregulation, Ofcom does not provide explanations as to where it believes the high efficiency savings can be reasonably achieved from services that are approaching the end of their useful economic lives. The higher end of the proposed 2%-6% range is a significant step up from the efficiency assumptions used in previous TI charge controls.

Efficiency assumption for Ethernet services

35. A key factor required to deliver future efficiency savings is categorised as "leaver costs" associated with restructuring that affect both the total labour cost as well as some non-pay costs. Depending on the information source, these may be separately identified but need to be considered in their entirety when assessing the overall efficiency package.

⁵ As set out in response D9 of Ofcom's 24th s135, submitted 23 October 2015.

⁶ As set out in response D1 of Ofcom's 24th s135, forecasts for BT TSO is not available beyond 2016/17 because BT TSO and BT Wholesale discontinued the practice of creating and using PVEO analysis.

⁷ As set out in response D7 of Ofcom's 24th s135, submitted 29 October 2015.

⁸ BT Wholesale PVEOs for 2014/15 and 2015/16 are adjusted for items such as POLO recoveries from 3rd parties, additional staff costs into BT Wholesale, and reflecting reductions in volume-driven SG&A costs within cost transformation.

⁹ As set out in response A3 of Ofcom's 6th s135, submitted 19 December 2014.

36. Ofcom's focus in the LLCC2 Consultation relates to a more detailed breakdown of the BT TSO PVEO analysis which Ofcom considers relevant for the TI efficiency range. We note that adjusting for leaver costs and Career Transition Centre (CTC) payments reduces the average BT TSO efficiency down from 6.2% to 4.4%, and would have reduced the Ethernet efficiency estimate by 0.4% to 0.5% depending on the weighting used.
37. BT's October analysis also provided further information on disaggregating the Openreach PVEO analysis to reflect the following: efficiency initiatives most relevant to the Ethernet portfolio, adjustments to take into account implementation costs to deliver the expected efficiency savings, and evidence on Openreach performance against the targets set out in its PVEOs. Again, these adjustments are made to reflect the concerns BT had regarding the use of internal management accounting information for setting charges.
38. The table below shows that after applying these adjustments, the average efficiency for Openreach as a whole reduces from 5.1% to 4.0%, at the lower end of the 4% to 7% range proposed by Ofcom for Ethernet services.

Table3. Net efficiency savings based on analysis of PVEOs

	2014/15	2015/16	2016/17	2017/18	2018/19	Average
<i>Openreach (excl NGA) BRF1 (Sept Fcst 2014)¹⁰</i>	✂	✂	✂	✂		5.1%
<i>Openreach (excl NGA) 2014/15 Actuals, Sept Fcst 2015 & MTP</i>	✂	✂	✂	✂	✂	5.0%
<i>Openreach Sept Fcst including adjusted opex items & MTP¹¹</i>	✂	✂	✂	✂	✂	4.0%
<i>TSO (excluding overseas) adjusted for leaver costs and CTC payments</i>	✂	✂	✂ ¹²	✂	✂	✂

39. Using the same data source for BT TSO efficiency Table 3 also shows that regardless of the weighting used for Openreach and BT TSO, expected Ethernet efficiency should be no more than 4.5% based on BT's internal management forecasts.
40. BT's August response also stated that the internal planning documents build in stretch targets and BT's October analysis provided the additional evidence to show that, on a like-for-like basis, Openreach missed the aspirational targets set out in its PVEOs by more than 25%. As set out in Annex G of BT's August response, stretch targets are commonly used for internal management planning to incentivise performance, whereas the efficiency assumption used in price setting should be based on a balanced view of efficiency, and should take into account the asymmetric impact of regulation.

¹⁰ BT response to QA3 of Ofcom's 6th s135, submitted 19 December 2014, based on documents used for internal management purposes and contains forecast numbers as at September 2014 for 2014/15, with actuals being behind target.

¹¹ These include leaver costs and identification of cost savings as volume changes rather than underlying efficiency (as set out in paragraph 46, Annex E of BT's August response), plus unadjusted MTP values for the 2017/18 and 2018/19 years.

¹² As set out in response D1 of Ofcom's 24th s135, forecasts for BT TSO is not available beyond 2016/17 because BT TSO and BT Wholesale discontinued the practice of creating and using PVEO analysis.

41. BT noted in the October analysis that within Openreach a new “Business Corporate Delivery” division was created during 2014/15 and is the nearest proxy for the costs associated with business connectivity (Ethernet) services. The analysis shows that for 2014/15, the expected efficiency savings from this division between 3% and 4%. This is supported by the view that the provision of new Ethernet circuits tend to be associated with extensions of BT’s existing network, where potential efficiency savings can only come from increased labour productivity, which requires investment in recruitment and training.
42. The available evidence from forecast PVEOs do not support the higher end of the range proposed by Ofcom, particularly when viewed alongside other available evidence BT has provided in the August response and summarised in Table. Ofcom has not considered the weight of the evidence beyond the lower end of the range for Ethernet services in the LLCC2 Consultation.

Summary of efficiency ranges

43. Table 4 below summarises the range of evidence available for TI and Ethernet efficiency savings.

Table 4. Summary of sources of evidence on potential efficiency gains for TI and Ethernet

<i>Source</i>	<i>TI</i>	<i>Ethernet</i>	<i>Evidence</i>
<i>Updated forecast PVEO analysis</i>	1% to 2%	3% to 4%	Identifying specific cost savings within TSO PVEOs that are relevant to TI services
<i>Updated unit operating cost trend analysis using RFS data</i>	1% to 2%	2% to 7%, with an average of 4.5%	Average from 2011/12 to 2014/15. ¹³ For TI it excludes one-off items, Cumulo rebates and taking into account cost allocation changes. For both the estimates include historic catch-up already achieved and may not be expected to be repeated in the future.
<i>Historic PVEO analysis</i>	1% to 2%	3% to 5%	Does not include historic catch-up, so could over-state potential for future efficiency
<i>Benchmarking analysis</i>	BT has made catch-up improvements over time and has closed the gap towards the frontier company		
<i>TFP analysis</i>	Telecoms sector: 0.5% to 3.0%, clustering around 2% Wider ICT sector: 2% to 4%		Higher rate of TFP growth not consistent with a market that has been in sharp decline and expected to continue to do so, but could be considered for newer services
<i>Frontier shift</i>	0.25% to 3%, clustering around 1%		Based on TFP assumptions used by other UK regulators
<i>Previous Ofcom LLCC decisions</i>	2.5% in 2009 1.5% in 2013	2.8% in 2009 4.5% in 2013	Explicit consideration that no catch-up is required in the forward-looking assessment of expected efficiency gains
<i>Range based on above evidence</i>	1% to 2%, central estimate of 1.5%	2% to 5%, central estimate of 3.5%	

¹³ As set out in response to E2 of Ofcom's 24th s135, submitted 27 October 2015.

Question 5.1: Do you agree with our proposal to use dynamic AVEs? If not, what alternative would you propose and why?

44. In the LLCC2 Consultation, Ofcom proposes for capital and operating costs, and for both the TI and Ethernet baskets, to implement dynamic elasticities that respond to the change in mix of incremental costs and fixed and common costs over the control period (paragraph 5.64).
45. More specifically, Ofcom proposes *“to depart from the assumption that our CVEs and AVEs remain constant over the period for this control. Instead, [Ofcom] propose[s] to adopt dynamic CVEs and AVEs that adapt to the changing mix of incremental and fixed and common costs over the control period. [Ofcom] note[s] that this issue is particularly acute in TI services, due to the large volume movements forecast over the control. The changes in demand for TI services are more striking overall than for Ethernet services. However, Ethernet volumes are still forecast to grow strongly. Therefore [Ofcom] consider[s] it appropriate to adopt the dynamic elasticities for the Ethernet basket as well as the TI basket. For services where volume changes are more limited, static AVEs and CVEs can be a reasonable simplifying assumption.”* (paragraph 5.45).
46. For the purposes of the 2016 LLCC, BT agrees with Ofcom’s proposed approach to adopt dynamic AVEs.
47. This approach is important as it explicitly recognises fixed common cost will amount to a varying proportion of total costs as volumes change, contrary to the variable cost (i.e. total cost less fixed common cost) which is dependent on volume changes and the operation of the AVEs. This is reflected in the modelling approach adopted by Ofcom.

Accommodation and Transmission equipment

48. BT has concerns over the modelling of Accommodation and Transmission equipment costs. The model uses AVEs (and CVEs) based on BT’s LRIC model which assumes that the network is reconfigured to an optimal size as volumes change. This assumption is unrealistic where BT has a complex network designed to deliver the aggregate service volumes in prior periods and where it is complex, challenging and costly to reconfigure the network as volumes decline. This means that the LRIC-based AVEs and CVEs are inconsistent with the operation and management of network assets in practice and are too high for the TI charge control modelling. For the purposes of calculating the fixed common costs BT considers that the use of the LRIC-model based AVEs and CVEs is appropriate, but for modelling costs going forward lower AVEs and CVEs should be used. This will ensure the modelling reflects the real world constraints on network rationalisation as volumes fall. These concerns are set out in more detail in the answer to Question 7.1 below.
49. In particular, as volumes decline, Ofcom has assumed it is possible to “dispose” of assets. BT considers it highly unlikely it will be economic (or even possible in the case of accommodation, duct and cable assets) for the assets to be separated from the network and sold. This means the disposals approach relies on the assets being reallocated elsewhere.
50. This approach may be relevant in the case of duct and fibre (where, in theory, in the medium-term the rationalisation of the network or migration of end users from legacy services to 21CN based services duct and fibre assets may be released for re-use). However, this seems less likely in the case of Accommodation and Transmission assets where there is less scope to reallocate the costs to other legacy services as these also have declining volumes. This issue is also explored in more detail in the answer to question 7.1 below.

Question 5.2: Do you agree with our proposal to change the AVE weights from NRC to GRC? If not, what alternative would you propose and why?

51. In the LLCC2 Consultation, Ofcom proposes for both the TI and Ethernet baskets to change the AVE weights from NRC to GRC (paragraph 5.64). BT agrees with this approach. This is an appropriate approach where volumes are growing as it seeks to reflect the appropriate value of assets needed to deliver growing volumes.

Question 5.3: Do you agree with our proposal to model TI capital costs at the cost sector level? If not, what alternative would you propose and why?

52. In the LLCC2 Consultation, Ofcom proposes for the TI basket only, to make an adjustment to the modelling of capital costs to reflect the potential averaging errors that could arise from a change in the TI asset mix over the control period (paragraph 5.64). BT agrees with this approach for TI services. This is a better way to model TI capital costs given the diverse mix of assets and the substantial reduction in TI volumes over time.

Question 6.1: Do you agree with our revised approach to balancing the use of SCAs and glide-paths in case of charges significantly above cost? If not, what alternative would you propose and why?

53. In the LLCC2 Consultation, Ofcom has completely changed the criteria it has applied to making SCA in its June 2015 LLCC Consultation.
54. In the June 2015 LLCC Consultation, Ofcom made clear its strong preference to make any adjustments through glide-paths and that it would only make SCA in two circumstances:
 - First, consistent with all previous regulatory practice, that it would make such adjustment only when there were *“distorted pricing signals If charges are significantly above DSAC (or possibly) FAC or below DLRIC, we propose to consider a starting charge adjustment”*. Ofcom held this criterion was not met in the current Market Review.
 - Second, Ofcom introduced new but highly limited criterion, namely where there were *“excessively high or low margins driven by: changes in cost allocations (and accounting errors) between regulated markets...”*. Although, Ofcom proposed in its June 2015 LLCC Consultation to make certain changes to the SCA for both Ethernet and TI services on this basis, for all the reasons set out in BT’s August 2015 LLCC Response, this was wrong in this case.
55. However, both circumstances provide clear and transparent criteria for testing whether any SCA should be made and, in respect of the first circumstance, was entirely consistent with all previous regulatory decisions.
56. Now Ofcom in its current Consultation instead seeks to introduce a “revised approach” for SCA. This still recognises that there should be *“.... a greater emphasis on the use of glide-paths to close the forecast gap between charges and costs over the control period”*. BT welcomes this as a general principle (for which it has pressed in its previous submission).
57. However, whilst, in its LLCC2 Consultation, Ofcom sets out its justification for its “revised approach”, it is difficult to discern any concrete criteria for assessing when and how this revised approach to SCA would apply in any charge control. For example, Ofcom merely suggests *“Therefore, in our regulatory judgement, the appropriate balance between the use of SCAs and glide-path should not ignore the benefits to customers from a quicker reduction in charges achieved through SCAs but should place a higher weight on the productive and dynamic efficiency benefits associated with the use of a glide-path (from which customers are likely to benefit from in the future)”*.
58. It may be a matter of regulatory judgment as to the weight that Ofcom should place upon the respective economic issues in formulating the criteria it will use for applying such SCA, but it still requires Ofcom clearly to set out the precise test criteria Ofcom will apply in deciding whether to make such adjustments. Merely claiming that it is all a matter of “regulatory judgment” does not allow a transparent understanding of how such SCA are to be made.
59. A clear statutory requirement is placed upon Ofcom to have regard to *“the principles under which regulatory activities should be transparent, proportionate, consistent, and targeted only at cases in which action is needed”*: s. 3(3) of the Communications Act 2003. Unspecified criteria as to when and how Ofcom should make any SCA in any market review do not conform with the duty of transparency under s. 3(3). Furthermore, no proper assessment of whether the adjustments are proportionate and targeted only at cases where action is needed can be made if there are no clear and transparent test criteria as to when such adjustments will be made.
60. Ofcom cannot demonstrate that its regulatory interventions are consistent if it introduces new tests from market review to market review and fails to specify the precise test criteria it will apply. Indeed, a fundamental tenet of all regulatory practice, certainly where UK law is directly derived from EU Directives (as in the case of the common regulatory framework for electronic communications), is legal certainty, i.e. that those affected should know *“without ambiguity as to*

what are his rights and obligations and may take steps accordingly". Unspecified criteria as to when precisely SCA will be made in market reviews, lack such legal certainty.

61. In the LLCC2 Consultation Ofcom set out its revised proposals for balancing the use of SCAs and glide-paths where charges are significantly above cost. BT disagrees that SCAs are necessary, particularly for TI services, and considers that Ofcom has placed undue weight on the benefits from bringing charges quickly into alignment with costs, compared with the benefits of glide-paths. The alignment of charges with costs should be achieved through glide-paths alone. BT sets out the reasons for supporting this approach below.
62. Ofcom's revised proposals follow from Ofcom's estimate that:
- BT's charges for controlled services are likely to be significantly above cost at the start of the control period:
 - *"In summary, over the first two years of the current control BT's rates of return on the services of particular interest to the 2016 LLCC have been more than double BT's cost of capital. BT's reported returns in excess of its WACC (i.e. 9.9%) in 2014/15 represent around 29% of revenues for low bandwidth TI services and around 25% of revenues for AISBO non-WECLA services."* (6.37)
 - *"We estimate that in the final year of the current control BT's ROCE will reach about 20% and 30% for Ethernet and TI services, respectively. These returns are significantly in excess of its cost of capital."* (6.38)
 - BT's charges for controlled services are likely to be significantly above cost for reasons other than efficiency or volume growth:
 - *"In summary, we consider that:*
 - *BT's return for the business connectivity services relevant to the charge control has been persistently above its cost of capital for a number of years;*
 - *BT's returns appear likely to remain above its cost of capital for the remainder of the current control period; and*
 - *these high rates of return do not appear to be primarily due to outperformance by BT against the efficiency and volume assumptions used in setting the 2013 LLCC. Indeed, such outperformance appears to be a relatively small factor in explaining BT's high rates of return."* (6.43)
63. Ofcom's analysis of each of the proposed considerations, when balancing the use of SCAs to the Ethernet and TI baskets, is summarised in Table 6.1 (paragraph 6.69).
64. In paragraph 6.73, Ofcom says: *"Reflecting this balance of emphasis, we propose to make a 5% SCA for TI services and a 10% SCA for Ethernet services. At these levels we estimate that the majority of the difference between forecast revenues and costs in 2015/16 would be closed by a glide-path."*
65. With regard to the implementation of Ofcom's proposals (paragraph 6.74):
- Ofcom's proposed SCAs as set out in the LLCC2 Consultation will apply correspondingly to the proposals in the June 2015 LLCC Consultation; and
 - the SCAs proposed in the LLCC2 Consultation require BT to make price reductions on the first day of the charge control, and therefore BT will not be required to give 28 days' notice under proposed Condition 7.4(b) of the SMP conditions. This is because the proposed SCAs are required by Ofcom and therefore Condition 7.3 applies.

66. BT's significant concerns with Ofcom's proposals relating to SCAs are set out in our August 2015 LLCC Response. Our comments in the August 2015 LLCC Response remain applicable and should be read in conjunction with our comments below, which focus on Ofcom's revised proposals included in the LLCC2 Consultation. The approach proposed in the LLCC2 Consultation does not address BT's concerns set out in the August 2015 LLCC Response. In fact, BT's concerns are further increased.

TI SCA

Evidence on returns for TI services

67. As BT explained in the August 2015 LLCC Response, in the case of TI services, the returns appear high because many of the assets have become fully-depreciated or near fully-depreciated, which tends to distort the reported level of profitability. As BT also explained, on the basis of costs consistent with a hypothetical market entrant, returns would be considerably lower. DotEcon¹⁴ explored this issue and found there are a number of reasons why reported returns may appear high for services where assets are approaching the end of life.
68. An examination of the TISBO market (up to and including 8Mbit/s) returns is set out in Table 5 below.

Table 5: Return on mean capital employed (ROCE) TISBO (up to and including 8Mbit/s)¹⁵

	04/05	05/06	06/07	07/08	08/09	09/10	10/11	11/12	12/13	13/14	14/15
<i>return</i>	31	49	-3	97	93	108	146	201	166	152	138
<i>MCE</i>	1,659	1,453	1,315	1,099	1,123	1,227	1,069	857	778	541	451
<i>ROCE</i>	1.90%	3.40%	-0.30%	8.80%	8.10%	8.80%	13.70%	23.50%	21.40%	27.90%	30.60%
<i>WACC</i>	12.1%	12.1%	11.4%	11.4%	11.0%	11.0%	9.7%	9.7%	9.9%	9.9%	10.8%

69. The low bandwidth TISBO ROCEs were below the weighted average cost of capital ("WACC") up until 2009/10 and it is only in recent years that the returns have been greater than the WACC. The growth in ROCE in recent years is entirely attributable to the decline in Mean Capital Employed ("MCE") as returns have in fact been in decline since 2011/12. As such, Ofcom's representation of returns in Figure 6.1 of the LLCC2 Consultation is misleading, and diminishes Ofcom's case that SCA are necessary in this market given the life-cycle effects
70. For this reason it is not reasonable to base a decision to impose SCA on an assessment of unadjusted reported returns particularly where a large proportion of the asset base is fully or near fully depreciated.

Evaluation of glide-path or SCA for TI services

71. In Table 6.1 of the LLCC2 Consultation, Ofcom summarises its evaluation of whether to propose applying SCA to TI services against 5 considerations.
72. BT agrees that against three of the five considerations there should be more emphasis on glide-paths rather than SCA due to consideration of '*Ensuring the regulated firm has the opportunity to recover its efficiently incurred costs*'; '*Avoiding discontinuities in charges over time*' and '*Promoting efficient migration*'. Despite this, Ofcom proposes to impose an SCA for TI services giving a higher weight to the consideration '*Benefit to customers and end users associated with bringing charges quickly into line with costs*' over the other three considerations, contrary to its own analysis of the relevant considerations.

¹⁴ See Annex L of BT's August 2015 LLCC Response.

¹⁵ Source: BT's regulatory financial statements, using restated figures used where applicable

73. BT considers that Ofcom's decision is flawed in that it gives too much weight to the short-term benefit to customers and end users, whilst under-stating the importance of the other three considerations, and in particular '*promoting efficient migration signals*' and '*avoiding discontinuity in charges over time*'.
74. TI is a declining market at the retail layer with a resulting reduction in the level of competition as firms change their business models to focus on new services (such as Ethernet / IP based services). Therefore, it is less likely that CPs will pass on one-off TI price reductions to their end user customers meaning that the economic benefit identified by Ofcom may not materialise in practice.
75. If one-off cuts in TI prices are not passed on directly to end users, they are also unlikely to be used by CPs to promote competition in retail TI services, e.g. new investment or innovation in retail services. With the rapid decline of traditional services and their substitution by cheaper better replacement services, it is implausible that the one-off price cuts would lead to additional innovation and investment in these legacy services.
76. We agree with Ofcom that as TI services are experiencing rapid technological change, the use of a glide-path would continue to encourage efficient migration to the benefit of society.¹⁶ In fact, a one-off price reduction is likely to unnecessarily delay efficient migration. In the TI basket there is a further consideration, depending on future inflation and the final value of X, there may be a price cut at the start of the charge control followed by price increases. This would not be a sensible price profile in a market where it is important to provide the right price signals to encourage migration.

Conclusion - SCA for TI services

77. BT considers that Ofcom's evaluation of reported returns for legacy services with highly depreciated assets is not a sound basis for considering whether an SCA might be appropriate. Notwithstanding that, Ofcom's reasoning for preferring emphasising an SCA over a glide-path relies on direct or indirect benefits to end users that are unlikely to materialise, whilst ignoring the very likely dis-benefits of undermining efficient migration signals and avoiding discontinuity in charges over time. Moreover, Ofcom ignores its own analysis in paragraphs 6.71 and 6.72, which logically leads to the conclusion that a glide-path, rather than an SCA, should be proposed for TI services. The imposition of an SCA to TI services is, therefore, unjustified and disproportionate.

Ethernet SCA

Evaluation of glide-path or SCA for Ethernet services

78. In Table 6.1 of the LLCC2 Consultation, Ofcom summarises its evaluation of whether to propose applying SCA to Ethernet services against 5 considerations.
79. BT agrees that against two of the five considerations there should be more emphasis on glide-paths rather than SCA due to consideration of '*Ensuring the regulated firm has the opportunity to recover its efficiently incurred costs*'; and '*Investment in competing infrastructure by other CPs*'. Despite this, Ofcom proposes to impose an SCA for Ethernet services giving a higher weight to the considerations '*Benefit to customers and end users associated with bringing charges quickly into line with costs*' and '*Promoting efficient migration signals*'.
80. The promotion of efficient migration signals is in part a result of the decision to implement a SCA for TI services. If the SCA were not imposed for TI services, as we argue above, there would be less justification to impose a SCA for Ethernet services as there would be no narrowing of the price gap between TI and Ethernet services. BT therefore considers the impact on migration signals will be marginal at best, once an appropriate adjustment has been made to the TI proposals.

¹⁶ Paragraphs 6.65-6.68 of the November 2015 LLCC Consultation.

81. A SCA for Ethernet services would adversely impact incentives to invest in two ways:
- lower prices make it less attractive for BT and other CPs to invest in Ethernet services, by reducing returns and making Ethernet services less attractive in comparison with alternative opportunities for investment; and
 - BT and competing infrastructure providers will find investment in Ethernet services less attractive as future prices are less certain due to Ofcom's approach to SCAs. This is an enduring effect as it is uncertain whether and how SCAs might apply in future charge controls if Ofcom's SCA policy were adopted.
82. Ofcom recognises the effect on investment incentives for competing infrastructure providers but insufficient weight is given to this impact. Ofcom must also consider BT's incentive to invest in its considerations, which it fails to do.
83. Ofcom recognises BT faces some competition in the SMP market from competing infrastructure providers.¹⁷
84. In response to the June consultation, Virgin Media said *"Above all, we consider that in setting new charge controls, it is vital that Ofcom seeks to preserve investment incentives for the industry as a whole and does not undermine existing investments or markets. This will ensure that the substantial private investment in infrastructure that has been made to date remains sustainable and the further investment to which Ofcom aspires can take place."*¹⁸ It further states *"Virgin Media believes that the price adjustments should be introduced by a glide path only approach as opposed to any form of one-off starting charge adjustment."*¹⁹
85. Furthermore City-Fibre say *"The approach taken by Ofcom to the CPI-X% regulation of BT's active products will lead to significant short term price erosion. This approach would result in transfer of market share back to BT..., and result in monopoly network infrastructure which, while low cost in the short term, will not deliver long term efficiency."*²⁰
86. Ofcom has consistently expressed a strong preference for glide-paths as it is better suited to promoting competition and encouraging investment and innovation²¹. Lower prices and returns from Ethernet services clearly make Ethernet services a less attractive investment proposition for competing infrastructure providers and the introduction of a large one-off price reduction will have a much larger detrimental impact on their incentives than a glide-path only approach.
87. Furthermore, the proposed one-off price reduction will not only unnecessarily reduce investment incentives in itself, through lowering prices sooner than a glide-path, but the basis on which Ofcom proposes to evaluate the introduction and size of the SCA will increase uncertainty about likely future returns. Given infrastructure investments are long term in nature this will significantly exacerbate the reduction in investment incentives to the detriment of end customers.
88. Finally Ofcom should not ignore the impact on BT's investment incentives (Ofcom only consider impact on other CPs' incentives in its criterion) as BT is, and will continue to be, a significant investor in infrastructure to support Ethernet services. BT considers the uncertainty of Ofcom's approach to SCAs, as discussed above, will significantly undermine its incentives to invest now and in the future.

Conclusion - SCA for Ethernet services

¹⁷ LLCC Consultation para 6.58

¹⁸ Para 1.9 http://stakeholders.ofcom.org.uk/binaries/consultations/llcc-dark-fibre/responses/Virgin_Media.pdf

¹⁹ Ibid page 4

²⁰ P16 <http://stakeholders.ofcom.org.uk/binaries/consultations/llcc-dark-fibre/responses/CityFibre.pdf>

²¹ 4.107 Review of BT's Network Charge Controls, Ofcom, 15 September 2009

89. Ofcom should place more emphasis on the investment incentives and, by adjusting the SCA on TI services, less weight would need to be placed on promoting efficient migration signals. These factors mean that Ofcom should reconsider the need for an SCA for Ethernet services as the arguments in favour of a glide path outweigh those that might support a SCA.

Question 7.1: Do you agree with our revised X values for the Ethernet and TI baskets? If not, what alternative would you propose and why?

90. Ofcom's revised proposals in relation to the new charge controls for Ethernet and TI services are in Table 7.1 of the November 2015 LLCC Consultation:

Basket	Overall cap (value of X)	Starting charge adjustment
Ethernet	CPI-12.50%	-10%
TI	CPI-3.50%	-5%

91. Ofcom further proposes the following ranges (paragraph 7.3):

- Ethernet basket – a range of X between -6.50% to -14.50% around a base case control of -12.50%; and
- TI basket – a range of X between +2.50% to -5.50% around a base case control of -3.50%.

BT does *not* agree with Ofcom's revised X values for either the Ethernet or the TI baskets, as we consider these too low. We set out below our reasoning and proposed alternatives.

Ethernet services

92. BT considers the base case X of -12.5% too low, and that the X should be -9.1% with an SCA of 1.8%, as per Table 6 below.

Table 6 – BT's Estimate of Ethernet 'X'

	Ethernet 'X'
<i>Ofcom's calculation per LLCC2 consultation</i>	-12.50%
Adjustments:	
Allow all Restructuring costs	+0.75%
Correct the modelling of QoS costs	+1.25%
Increase Fibre AVE (0.2 to 0.8)	+3.00%
Reduction in Efficiency (5% to 3.5%) ²²	+1.25%
<i>BT's estimate of Ethernet 'X' (with SCA of 10%)</i>	-6.25%
Impact of reducing SCA (SCA reduced from 10% to 1.8%) ²³	-2.85%
<i>BT's estimate of Ethernet 'X' (with SCA of 1.8%)</i>	-9.10%

93. The rationale for the proposed value of X, in respect of the factors outlined in Table 6 above, is laid out in the August 2015 LLCC Response and in the responses to Questions 3.1, 4.1 and 6.1 above.

²² BT's August 2015 LLCC Response, paragraph 259.

²³ BT's August 2015 LLCC Response, Table 13.

94. Since the June 2015 LLCC Consultation, Ofcom has changed the AVEs but it has not addressed our concerns in relation to the Fibre AVE, set out in the August 2015 LLCC Response. We outline below some additional points relating to the Fibre AVE.

Fibre AVE

95. BT notes that Ofcom has changed the calculated AVEs since the June 2015 LLCC Consultation and now proposes a weighting by GRC (as opposed to NRC). The result of this is that the EAD Fibre AVE has reduced from 0.20 to 0.13. Although BT does not object to the use of GRC to weight the AVEs in the leased line charge control, BT reiterates the point that the EAD Fibre AVE applied in Ofcom's charge control modelling is too low, and does not reflect that the Ethernet access fibre network footprint is still increasing.
96. BT refers to the August 2015 LLCC Response²⁴ for its explanation as to why it is inappropriate to use the proposed low EAD fibre AVE.
97. Since the June 2015 LLCC Consultation, BT has undertaken alternative analysis which illustrates why the EAD Fibre AVE applied in the LLCC2 Consultation is too low. BT has looked at Ethernet provisions and the work required for connecting a new Ethernet circuit.

Figure 1 – Ethernet orders by category

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98. Figure 1 shows historic data relating to Ethernet provision. Every Ethernet order is assigned a category depending on the existing fibre infrastructure available to serve that specific provision. As the category increases (from 1-4) so does the amount of fibre infrastructure build required to serve that provision (i.e. a fibre footprint expansion is required). The Ethernet order categories are explained in more detail in Table 7 below.
99. An analysis of Ethernet orders by category (Figure 1) shows that a majority of Ethernet provisions are category 2 or above (i.e. they require some additional access fibre to reach the customer's premises). In March 2015, over 80% of Ethernet orders were classified as category 2 or above. Note the proportion of Ethernet orders which are category 2 or above has remained at approximately 80% since March 2011.

²⁴ BT's August 2015 LLCC Response, paragraphs 91-95.

Table 7 – Category definition

Category	Order category definitions
1	Fibre connection available between customer's premises. Possible installation and connection of fibre and equipment within the customer's premises and service testing and commissioning required.
2	Fibre connection is available between Openreach network distribution nodes. In addition to possible category 1 activities installation of duct and fibre (cable or tubing with blown fibre) is required from Openreach network distribution node(s) to the customer's premises.
3	In addition to possible category 1 and 2 activities a new spine fibre connection is required in part or whole between Openreach distribution nodes and serving exchange.
4	In addition to possible category 1, 2 or 3 activities a new core fibre cable is required between exchanges.

100. This analysis suggests that Ofcom's use of a low EAD Fibre AVE (0.13 in the LLCC2 Consultation) is not reflective of reality. An AVE closer to '0' rather than '1' implies a network which is fully developed and can theoretically serve a majority of orders using the existing fibre infrastructure. The Openreach Ethernet order data (Figure 1) shows this to be untrue. BT considers the high level of provisions that still require further fibre to be laid, suggests Ofcom should revert to its assumption in the 2013 LLCC and apply an EAD Fibre AVE of 0.8.²⁵

TI Services

101. BT considers the base case X of -3.5% will result in prices that are too low, and that the X should allow price increases of CPI + 2.5% consistent with Ofcom's consultation range. This is because of a number of factors set out in Table 8 below. Setting X at this level will ensure that migration incentives continue for customers currently using legacy business connectivity services.

Table 8: Proposed adjustments to the TI X modelling

	Impact on TI "X"
Base Case X	-3.5%
Adjustment to the Accommodation CVE (using a figure of 0.13)	+2.8%
Reduce the AVE for Accommodation and Transmission Assets to 0.13	+4.0%
Reduce the efficiency factor to an improvement of 1.5% p.a.	+2.3%
Moderation of duct and fibre "disposals"	+0.5%
Starting Charge Adjustment moved into the glide path	-1.7%

Ofcom model's treatment of Accommodation and Transmission assets is unrealistic

102. The TI services use SDH transmission assets based in BT's exchange buildings, which results in transmission and accommodation costs in the TI basket. BT is constrained in the ability to rationalise the transmission network assets due to the shared nature of these assets.

²⁵ Business Connectivity Market Review: Ofcom's Statement, 28 March 2013, paragraph 20.374.

103. The charge control model assumes that both transmission assets and accommodation assets will vary as the volume of TI services declines, based on using a Long-Run Incremental Cost (LRIC) relationship between costs and volumes. This approach makes an explicit assumption that the network assets can be rationalised as volumes change. The reality of running the network is very different, with reduction in transmission equipment lagging behind volume changes. BT has referred to this adjustment to CVEs as costs being “sticky downwards” to reflect the time-lags between falling volumes and the ability to rationalise the network required to provide the TI services.

104. There are two elements that lead to changes in the accommodation and transmission costs related to TI services: the volume of transmission network assets, such as the number of multiplexors (muxes) in the network, and the way in which these assets are apportioned to services.

105. Table 9 below shows the relationship in recent years between the volume of PPC circuits (illustrated by the volume of 2Mbit local ends) and the number of SDH muxes in the network and the associated accommodation footprint and power consumption.

Table 9 PPC volumes and SDH equipment volumes and associated power consumption

SDH	2011/12	2012/13	2013/14	2014/15
TI Volume (2Mbit local ends)	217,509	188,343	140,995	127,330
Equipment count (SDH muxes)	✂	✂	✂	✂
Power usage (GWH)	✂	✂	✂	✂

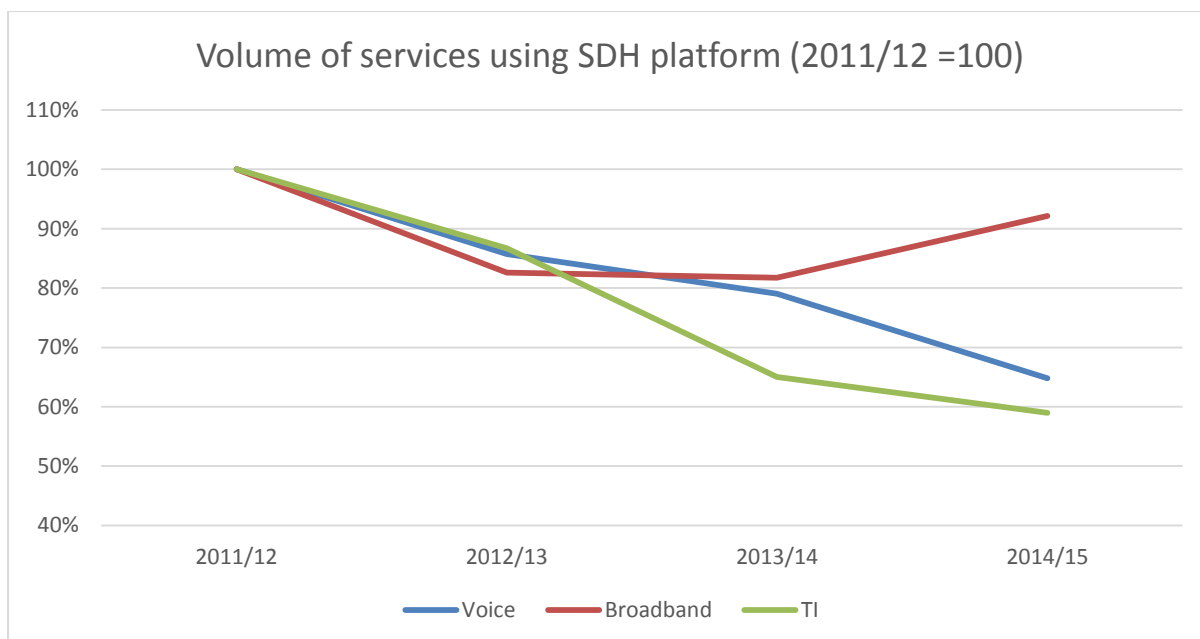
106. Table 9 shows that the volume of SDH network assets is broadly unchanged over the past four years despite a significant reduction in PPC volumes.

Figure 2 SDH cost allocation changes between 2011/12 and 2014/15

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107. Figure 2 above shows how the cost allocation of the SDH network has changed over the past four years, with a significant reduction to TI services, whilst the percentage allocation to broadband and voice services has increased. There is therefore a time lag between the volumes decrease and the reduction in volume of network equipment (and associated accommodation).

Figure 3 Relative volumes of voice, broadband and PPCs over the same time period



108. Figure 2 and 3 above show that the linkage between cost allocation and volumes is not straight forward, with allocation being dependent not only on the volume changes of TI but also on the volumes of other services sharing the SDH platform, such as voice and broadband.

109. The increase in allocation to voice services can be explained by the migration of circuits from the PDH network onto SDH as the PDH network has been consolidated. This is unlikely to repeat in future years to the same extent. The increase in allocation to broadband has been driven by the growth in backhaul bandwidths, however as 21CN broadband is rolled-out to more exchanges, this trend is less likely to continue in future years. As a result of the trends in voice and broadband services, it is probable that in future the allocation of cost to TI services may increase even though TI volumes are forecast to continue to decline.

Rationalisation plans for the SDH network

110. To assess the impact on the TI cost modelling, BT has examined the extent to which it is economic to rationalise the SDH network. Current analysis of SDH utilisation shows that TI volume reductions would enable the number of SDH network structures to reduce by around 2.5% per annum up to 2018/19. If we make the assumption that there will be no reallocation to or from other services sharing the SDH platform, the forecast reduction in TI volumes of around 20% per annum is consistent with an AVE of approximately 0.13²⁶ for transmission equipment, and consequently for the accommodation occupied by this equipment. This contrasts with recent years where the SDH network has been broadly unchanged despite volume reductions.

111. The specialised accommodation costs cannot be reduced as transmission equipment is reduced in the short to medium term, as it is only when a whole suite of equipment is unused that the floor space can be cleared and made available for re-use. Individual rack spaces that house unused equipment within a suite cannot readily be re-used because the space is inaccessible. This suggests that the 0.13 AVE (as calculated above for SDH equipment) should be considered as an upper limit on the CVE that should be used for accommodation.

112. The variability of network and accommodation costs with volumes differs from the values in the LRIC model because it is not practical (nor cost effective) to rationalise the network to an “optimal” configuration assumed by the LRIC model. BT considers a more robust way to model costs is to consider how accommodation costs are likely to be variable in the medium term.

²⁶ This is calculated as 2.5% reduction in structure divided 20% PPC volume decline.

Moderation of duct and fibre “asset disposals”

113. The model assumes that as the volume of TI services declines, duct and fibre assets that become surplus to requirements can be either allocated to other services or re-used.
114. The discussion above on the treatment of transmission and accommodation assets shows that there is limited scope to reallocate assets used by the SDH network to services other than TI that share the platform. This means that Ofcom’s approach assumes that all the duct and fibre assets can be reused by other services. BT considers that this is over-optimistic as this requires both a demand for new fibre to exist in the same location and for there to be a shortage of fibre. This is unlikely to happen in all cases where BT can rationalise the network, meaning that an adjustment is needed to reduce the level of assumed re-use of the duct and fibre to reflect the “asset disposals” assumption.
115. BT suggests the duct and fibre “asset disposal” factor is moderated by a factor of one-half to take this into account.

Efficiency

116. The efficiency relevant to TI services is too high for the reasons set out in the response to Question 4.1 above. BT considers that this should be a maximum of 1.5% for TI services.

Question 8.1: Do you agree with our proposals for BT's regulatory financial reporting, including in particular:

- a. the proposed Consistency with Regulatory Decisions Direction;
- b. the proposed Direction modifying requirements relating to the preparation, audit, delivery and publication of the Regulatory Financial Statements, and Direction modifying requirements relating to the form and content of the Regulatory Financial Statements;
- c. the proposed Adjusted Financial Performance Direction and
- d. the proposed Network Component Direction? If not, what alternative would you propose and why?

117. We set out below BT's comments on Ofcom's proposals for BT's regulatory financial reporting. We first comment on the five proposed Directions (a-d above), and then make some additional comments in relation to Dark Fibre and TRCs reporting.

118. Please note that this response should be read in conjunction with our response to the Cost Attribution Review consultation of 13 November 2015 submitted on 15 December 2015 ("the December 2015 CAR Response"), and with our responses submitted in August 2015 to Ofcom's June 2015 LLCC and CAR Consultations ("August 2015 LLCC Response" and "August 2015 CAR Response", respectively).

a. the proposed Consistency with Regulatory Decisions Direction

119. Ofcom proposes that a number of adjustments should be made to our cost information in respect of fibre GRC, Duct, Openreach and TSO Software, electricity, property, general overheads and EE acquisition costs.

120. We have set out our comments on all but the last of these areas in our December 2015 CAR Response, which should be read in conjunction with this document. In the December 2015 CAR Response we set out why we consider that Ofcom has not demonstrated that the current allocation methodologies are inappropriate with reference to the Regulatory Accounting Principles ("RAP"), and therefore, that Ofcom has not met the test for replacing our existing methodologies. We also explain why, in any event, certain of the alternatives proposed, in particular aspects of the overheads and property proposals, are themselves not appropriate with reference to the RAP. For the reasons set out there we do not therefore agree with the proposed Direction.

121. We do however agree with Ofcom that transaction costs incurred in respect of our proposed acquisition of EE should be excluded from the costs of regulated products. It is not our intention that any of the purchase price of EE (£12.5bn) or the related transaction costs will be allocated to our regulated products in Financial Year 2015-16 or any future years.

122. We have the following detailed comments on the proposed Direction:

123. Ofcom proposes to define "BT Group PAC" as:

"BT Group PAC" means the cost attribution methodology specifying that:

- (a) costs must be attributed pro-rata to each and every cost category (e.g. activity group, plant group, residual) that has previously received an allocation of one or more of the following: (i) current pay costs, (ii) non-pay costs (excluding POLOs, other operating income and software capitalisation credits), (iii) capital expenditure at that level of the Regulatory Accounting System; and*
- (b) the pro-rata attribution to each cost category referred to in paragraph (a) of this definition must be calculated by dividing the total cost of (i) current pay costs, (ii) non pay costs, and (iii) capital expenditure included in that cost category by the total cost of (i) current pay costs, (ii) non pay costs, and (iii) capital expenditure in all cost categories at that level of the Regulatory Accounting System;"*

Within this definition “non-pay” should be amended to read “non pay costs (excluding POLOs, other operating income and software capitalisation credits”. The same comment also applies to the proposed definitions of “BT Wholesale PAC”, “Openreach PAC” and “TSO PAC”.

124. Ofcom proposes to define Openreach Product Revenues as:

““Openreach Product Revenues” means the cost attribution methodology specifying that costs must be attributed to each and every Product based on the proportion of total Openreach product revenues associated with that Product in the prior Financial Year;”

We suggest that Ofcom should change the term “Product” to “Openreach wholesale service” which is a specific term used in the RFS and our Accounting Methodology Document.

125. Ofcom proposes to define POLO as:

““POLO” means a payment made by BT to another communications provider for call termination;”

The definition of POLO should be amended to read:

“POLO means a payment made to another communications provider for the provision of telecommunication services, including call termination and the provision of terminating circuits”.

126. Direction 1.9.1 proposes that “(BT shall) attribute vacant space within any building in the same proportions as non-vacant space is attributed within that building”.

We suggest that this paragraph is amended to read “(BT shall) attribute vacant space in the same proportions as occupied space of that type”.

127. Direction 1.10.1 proposes that “in the case of property costs, BT shall separately identify and separately attribute the costs of each type of space”.

As “type of space” has not been defined we suggest that Ofcom names the types of space it requires us to separately identify and attribute i.e. specialised accommodation space owned by BT, specialised accommodation space rented by BT, office space owned by BT and office space rented by BT.

128. Direction 1.11 proposes:

“BT shall separate the costs currently included in activity group AG112 (Corporate Overheads) into the following cost groups and attribute the costs in each of these cost groups using the cost attribution methodology specified below”.

We suggest changing the word “separate” to “identify”. This change would provide us with some flexibility in how we implement the change in REFINE e.g. we may wish to group all cost categories with same treatment into a new cost pool (activity group or plant group).

129. Direction 1.11.9 proposes that:

“Costs of Corporate Special Projects (currently included in OUC CP) [shall be attributed] using the BT Group PAC methodology”.

We suggest that the following caveat be added to the sentence “ except for costs relating to the EE acquisition”.

130. Direction 1.11.16 part (iii) (a) proposes that:

“In the case of an Openreach line of business , insurance costs shall be attributed pro-rata to any cost category (e.g. activity group, plant group, residual) that has previously received an allocation of Openreach pay costs at that level of the Regulatory Financial Statements”

We suggest that this is amended to “In the case of an Openreach line of business, insurance costs shall be attributed using the Openreach Pay Methodology”. This would substantially be the same but would allow BT the flexibility to process the methodology at a level that is most efficient in APSIRE e.g. we may choose to use AG401 (Openreach Pay).

Similar observations apply to section ((ii)(b) BT TSO pay.

131. Direction 1.19 proposed that: “BT shall not attribute the costs of Group Restructuring to the Network Services in the BCMR Markets.”

Group Restructuring costs consist of redundancy payments cost of our Career Transition Centres and Property Rationalisation costs. However, Ofcom has not discussed such a methodology change in the Cost Attribution Review and these directions appear to conflict with the following proposed directions:

- 1.12.1 TSO Redundancy costs (currently included in OUC TX) using the BT TSO Pay methodology.
- 1.12.5 TSO Career Transition Centre costs using the BT TSO pay methodology.
- Direction for Adjusted Financial Performance:
 - 1.1 calculating for each financial year, an average of the property rationalisation costs incurred in the three prior Financial Years; and
 - 1.2 attributing that average to the BCMR Markets.

132. Direction 1.21 proposes that “BT must separately account for costs and volumes of the Featurenet with bandwidth of 64kbit/s and 2Mbit/s”.

We suggest amending this to read: “BT must separately account for any costs and volumes relating to Featurenet with bandwidth of 64kbit/s and 2Mbit/s in Residual.”

133. Direction 1.22 proposes that “BT shall not allocate the transactional costs of the anticipated acquisition of EE to BCMR Markets”.

We suggest amending “BCMR Markets” to “any SMP Market”

- b. the proposed Direction modifying requirements relating to the preparation, audit, delivery and publication of the Regulatory Financial Statements, and Direction modifying requirements relating to the form and content of the Regulatory Financial Statements**

Public reporting

134. In the November 2015 LLCC Consultation, Ofcom proposes that:

“BT must include the total costs and revenues for all of its dark fibre CISBO non-CLA services in the market summary for CISBO non-CLA. We also propose that BT must include the total costs and revenues for all of its TRCs in the market summary for all BCMR markets in which the services are provided.” (paragraph 8.15)

135. In the August 2015 LLCC Response (see response to Question 11.1), we explained that we consider that Ofcom should require us to report costs at a level consistent with that at which price remedies are imposed. Such an approach, consistently adopted in other markets (but not in the June 2015 LLCC Consultation), provides a clear link to the other remedies imposed.

136. BT agrees with Ofcom’s proposals in paragraph 8.15 of the November 2015 LLCC Consultation, which are in line with that approach.

137. We do note, however, that Ofcom is proposing two non-CLA markets and we understand that such disclosures would apply in each of these markets separately.

138. Ofcom further proposes that: “BT must provide the information that demonstrates BT has complied with the Dark Fibre basis of charges condition; 1Gbit/s EAD and 1Gbit/s EAD LA FAC unit costs, unit LRIC cost of excluded Network Cost Components. BT must also disclose the total volumes, average prices and revenues for its dark fibre non-LA and dark fibre LA services (including their variants) respectively, from when these services are commercially available. This information should be produced where applicable for i) internal and external circuits, and ii) rentals and connections. Rentals should also be separated by charging elements, i.e. separate information provided for local ends, terminating segment charge and main links. Where time

limited discounts and three year term products have been included, BT must separately disclose the discounted and non- discounted volumes and revenues.”(8.18)

139. We do not agree with the proposal to publish unit LRIC costs of excluded Network Cost Components. We consider that the remaining disclosures proposed are of themselves amply sufficient to allow stakeholders to assess the effectiveness of the remedies imposed upon us and to monitor our compliance with regulatory obligations. The LRIC disclosure proposed by Ofcom would allow our competitors to access information that is commercially sensitive to BT, in particular the unit prices of the electronic, which we consider to be confidential between us and our suppliers. We propose as an alternative, consistent with the approach adopted by Ofcom in other price compliance statements, that this information is supplied to Ofcom privately but redacted in the published version.

140. We discuss BT’s concerns relating to public reporting of Dark Fibre and TRCs (in particular in relation to the proposals in paragraphs 8.18 and 8.19 of the November 2015 LLCC Consultation) in more detail in paragraphs 137 to 158 below.

Private reporting

141. Ofcom proposes that (paragraphs 8.20-8.22):

“We have also reconsidered the proposed private reporting obligations on BT and further propose that BT provides Ofcom with the following Additional Financial Information (AFI) setting out the revenues and CCA costs for dark fibre LA and dark fibre non-LA services (including their variants):

- *Revenues, CCA costs (split down by Operating Costs, Depreciation, Holding Gains), Return, MCE, ROCE; and*
- *Costs for each service broken down by component.*

In addition to information provided publically on how the prices of the dark fibre and its 1Gbit/s EAD and 1Gbit/s EAD LA equivalents are derived, this schedule will contain details of the costs of the evolving dark fibre products and ensure monitoring of the effectiveness of the proposed dark fibre remedy as set out in Section 9 of the May 2015 BCMR Consultation and Section 8 of this June 2015 LLCC Consultation.

In relation to TRCs, we propose that BT must provide direct and indirect volume, revenue and cost information. This is the same information provided for TRCs reported in the fixed access markets (currently AFI1B-2). The purpose of this information is to demonstrate the impact of our proposed requirement in relation to TRCs on actual revenue and profits. We need to be able to assess to what degree BT continues to over or under recover its costs once charges are set, in order to assess whether our remedies are working as expected when we set them. This would also bring BT’s regulatory reporting requirements in line with those in the fixed access markets, as set out in the March 2015 Directions Statement.”

142. We accept to supply the information proposed confidentially to Ofcom. However, we note that the variants should be aggregated where necessary to ensure that the volume of information reported does not become disproportionate.

c. the proposed Adjusted Financial Performance Direction

143. In Annex 6 of the November 2015 LLCC Consultation, Ofcom proposed Direction is that:

“1. BT shall prepare the “Adjusted Financial Performance at a market review level” statement and the “Adjusted Financial Performance at a market level” statement in order to show the impact on the Regulatory Financial Statements of:

1.1. calculating, for each Financial Year, an average of the Property Rationalisation Costs incurred in the three prior Financial Years; and

1.2. attributing that average to the BCMR Markets.”

We consider this approach to be reasonable and consistent with the approach Ofcom has adopted to the Adjusted Performance Schedule in other markets.

d. the proposed Network Component Direction

144. In the November 2015 LLCC Consultation, Ofcom proposes that (paragraph 8.25):

“the current cost components Ethernet Backhaul Direct and Ethernet Backhaul Direct Resilience should each be split into two separate cost components: an “active” component and a “passive” component:

- The active component should cover the costs associated with the “active” Plant Groups (currently WDM-Metro Link for EBD rentals and Metro-Core link and Core-Core Link for EBD Resilience). These Plant Groups include power costs, equipment, relevant software, accommodation, and plant and maintenance costs.*

The costs for this component should also include an appropriate element of Cumulo Rates non-NGA costs.

- The passive component should cover the costs of “passive” Plant Groups (currently Backhaul Fibre, WDM-Metro Length, and AISBO ECC Credit for EBD Rentals, Core Fibre, Core-Core Length and Metro-Core Length for EBD Resilience). These Plant Groups cover the costs of any activities required to maintain and support Fibre and Duct infrastructure. These costs include, accommodation costs (excluding electricity costs required to power electronic equipment) relevant software, accommodation plant and maintenance costs. The costs for this component should also include an appropriate element of Cumulo Rates non-NGA costs.”*

145. We do not agree with this proposal. Ofcom has not clearly explained the purpose of making such a change, and in particular, the way and purpose it or other stakeholders would use this additional information.

146. It is insufficient for Ofcom to note that *“it should be straightforward for BT to implement and would make the reporting of these services consistent with BT’s reporting of the other regulated business connectivity services”* (8.24) or that: *“The proposal therefore seeks to improve the presentation and usability of the RFS and ensure that the RFS remain relevant, thereby increasing transparency. Ultimately, this promotes competition.”* (8.35)

147. We do not agree that such a general view can be used to justify this proposal. Transparency does not promote competition in all instances. Indeed, it is a feature of an effectively functioning competitive market that firms are able to maintain confidentiality of commercially sensitive information, for example in order to benefit from the intellectual property they have developed. In many instances transparency is indeed necessary, for example to allow investors to make informed decisions, but this cannot lead to the conclusion that transparency promotes competition in all circumstances. Ofcom must properly balance the benefits of each of the disclosures it requires against the potential harm to BT resulting from such disclosure.

148. In the absence of any explanation as to the purpose for this information, we are unable to suggest an alternative proposal and would recommend that the current EBD network components remain unchanged.

149. In addition to the above, we have the following more detailed comments to make regarding Dark Fibre Reporting, TRC reporting, Price Notification and TI Sub Caps.

Dark Fibre reporting

150. In the November 2015 Consultation, Ofcom proposes changes to BT’s regulatory reporting requirements in relation to Dark Fibre. BT has significant concerns about Ofcom’s revised proposal included in the November 2015 LLCC Consultation, which requires BT to publish information which under the proposals in the June 2015 LLCC Consultation, it was only required to provide privately to Ofcom. BT considers that any potential benefit to CPs (if at all) would be outweighed by the potential harm to BT (and others’) legitimate business interests, by the

proposed disclosure of commercially sensitive information which is highly confidential to BT. We explain our concerns in more detail below.

151. In Section 9 of the May 2015 BCMR Consultation, Ofcom has proposed a Dark Fibre Access obligation, which requires BT to provide other CPs with unlit optical fibre circuits, enabling them to provide leased line services using their own electronic equipment. Ofcom proposed a 'basis of charges' condition requiring BT to price Dark Fibre Access by reference to its EAD 1Gbit/s active products less the LRIC of the active elements of those products.

152. Ofcom's June 2015 LLCC Consultation contained Ofcom's detailed consideration and proposals concerning the form of the basis of charges condition for the proposed Dark Fibre Access remedy, and the guidance concerning the costs to be included in the 'minus' element of the active-minus pricing calculation.

153. Importantly, in the June 2015 LLCC Consultation, Ofcom proposed that BT should provide *privately* the schedule BCMR EAD/EAD LA 1Gbit/s component LRIC and FAC. The purpose of this schedule is to ensure monitoring of BT's implementation of the proposed Dark Fibre remedy as set out in Section 9 of the May 2015 BCMR Consultation and Section 78 of the June 2015 LLCC Consultation.

154. In the November 2015 Consultation, Ofcom refers to stakeholders comments, in particular:

- UKCTA said that: *"Ofcom should [...] require more information on the EAD 1G service, providing more granular information around component reporting in recognition of its proposed status as the active reference product for a passive alternative."* (paragraph 8.10); and
- The Passive Access Group said that: *"Ofcom's proposal for an active minus approach to dark fibre pricing will suffer from a lack of transparency."* and that *"[a]lternative operators will still face considerable uncertainty about the value of LRIC because: [...] the input cost data will not be available to CPs [...]"* (paragraph 8.11).

155. In light of those comments, Ofcom says:

- *"it is important that BT provides additional information that would enable the monitoring of compliance with, and the effectiveness of, the remedies proposed in the May 2015 BCMR Consultation and the June 2015 LLCC Consultation. This information would provide transparency on how BT has attributed costs across services and mitigates against the risk of double recovery of costs or that costs might be inappropriately attributed to particular services. We consider that this information would also be a useful source of information and would serve as an anchor point to reconcile other data, in order to support our decision making in relation to wholesale leased lines markets."* (8.13)

and:

- *"We agree with stakeholder comments about the importance of transparency of information available to stakeholders on the 1Gbit/s EAD services and on how the dark fibre equivalent is priced in relation to these services on an ongoing basis. The information that we proposed in the June 2015 LLCC Consultation to be published would not have allowed stakeholders to compare the dark fibre services they purchase with their reference products. We consider that stakeholders should be provided with such information about dark fibre services and the related 1Gbit/s EAD and 1Gbit/s EAD LA services separately. This would provide stakeholders with confidence that BT has complied with its regulatory obligations and enable them to assess the effectiveness of the dark fibre remedy we have imposed."* (8.17)
- *"We therefore propose that BT must provide the information that demonstrates BT has complied with the Dark Fibre basis of charges condition; 1Gbit/s EAD and 1Gbit/s EAD LA FAC unit costs, unit LRIC cost of excluded Network Cost Components. BT must also disclose the total volumes, average prices and revenues for its dark fibre non-LA and dark fibre LA services (including their variants) respectively, from when these services are commercially available. This information should be produced where applicable for i) internal*

and external circuits, and ii) rentals and connections. Rentals should also be separated by charging elements, i.e. separate information provided for local ends, terminating segment charge and main links. Where time limited discounts and three year term products have been included, BT must separately disclose the discounted and non-discounted volumes and revenues.” (8.18)

156. BT has significant concerns about Ofcom’s revised proposal included in the November 2015 LLCC Consultation, which requires BT to publish information which under the proposals in the June 2015 LLCC Consultation, it was only required to provide privately to Ofcom. BT considers that any potential benefit to CPs (if at all) would be outweighed by the potential harm to BT (and others’) legitimate business interests, by the proposed disclosure of commercially sensitive information which is highly confidential to BT.

157. Ofcom set out in its June 2015 LLCC Consultation, guidance on the appropriate level of EAD1000 costs incremental to Dark Fibre that should be deducted from the Dark Fibre price. These costs are predominately equipment costs incurred as an incremental cost each time a service is provided.

158. In our confidential August 2015 LLCC Response (annex A), and in response to recent responses to information requests,²⁷ we have set out that applying the principles proposed by Ofcom to derive the LRIC differential on Dark Fibre would lead to a stable differential during the charge control period. The estimated changes in the LRIC differential would account for between 2% and 3% of the Dark Fibre rental price by 2018/19. Therefore, movements in the LRIC differential would not materially impact the future price of Dark Fibre nor drive pricing volatility of Dark Fibre, which is the major concern for investment decisions.

Table 10 Relative volumes of voice, broadband and PPCs over the same time period

	15/16 Reference EAD 1G prices	DF LRIC differential in Ofcom’s approach	Forecast change on LRIC differential by 18/19	% change compared to Dark Fibre rental price
Dark Fibre LA	£3,000	✂	✂	✂
Dark Fibre STD	£4,200	✂	✂	✂

159. Ofcom proposes that the Dark Fibre Access remedy will take effect on 1 April 2017, and the price differential will be set at that time. The differential will potentially be revised in 1 April 2018 for the 2018/19 year. Given the incremental nature of the costs and the short forecast horizon, Ofcom should have confidence that these forecasts will be relatively reliable.

160. In summary:

- stakeholders already know the scope of the differential, which is unlikely to change significantly during the charge control period;
- the differential will not be a significant contributory factor in Dark Fibre pricing volatility; and
- the time horizon is short and there will be only one price change during the period.

²⁷ 27th LLCC S135

161. In those circumstances, it is clearly not the case that “operators will still face considerable uncertainty about the value of LRIC because: [...] the input cost data will not be available to CPs”.
162. This undermines any justification for requiring BT to publish this information. Set against this lack of clear benefit to CPs, is the potential harm disclosure of a breakdown of Openreach (and, by extension, supplier) costs, would or may cause to BT’s (and others’) legitimate business interests.
163. Ofcom acknowledges that “*BT does nevertheless face some competition in the SMP market from competing infrastructure providers.*” (paragraph 6.58). It is therefore highly detrimental to Openreach’s legitimate business interests and competition more generally to share the proposed detailed cost information with competitors and other stakeholders.
164. In addition to disclosing confidential Openreach information, the proposals would also entail disclosure of commercial information of Openreach’s equipment suppliers, which would or may harm those suppliers’ legitimate business interest and competition in the market.
165. Therefore, BT considers that it is inappropriate to share a breakdown of incremental costs publically, through a non-confidential statement, as Ofcom proposes in the November 2015 LLCC Consultation and the attached legal instrument. Such disclosure is unnecessary, unjustified and disproportionate and any potential benefit to CPs (if at all) would be outweighed by the potential harm to BT (and others’) legitimate business interests, by the proposed disclosure of commercially sensitive information which is highly confidential to BT.
166. For the avoidance of doubt, Openreach agrees to prepare Annex 1 “Dark Fibre Services” statement as outlined by Ofcom in Annex 6 of the November 2015 LLCC Consultation, for the purpose of providing the information privately to Ofcom, as previously proposed in the June 2015 LLCC Consultation.
167. As we say in paragraph 123 above. BT agrees with Ofcom’s proposal (at 8.15) that “*BT must include the total costs and revenues for all of its dark fibre CISBO non-CLA services in the market summary for CISBO non-CLA.*”

TRC Reporting

168. In the November 2015 LLCC Consultation, Ofcom proposes changes to BT’s regulatory reporting requirements in relation to Time Related Charges (“TRCs”), which are levied for services such as fault repair and providing or rearranging services where work is not covered within Openreach’s terms of service.
169. Ofcom proposes that:
- “*BT must include the total costs and revenues for all of its TRCs in the market summary for all BCMR markets in which the services are provided*” (paragraph 8.15). Ofcom considers that “[t]his would bring BT’s regulatory reporting requirements in line with those in the fixed access markets where TRCs are currently subject to charge control and included in the relevant market summaries, as set out in the March 2015 Directions Statement” (footnote 139) and that “*this proposal is in accordance with [Ofcom’s] decision in the May 2014 Regulatory Reporting Statement, which set out that volume and revenue information within the RFS should provide the appropriate level of detail and make clear in which market regulated products are reported.*” (paragraph 8.15).
 - “*BT must disclose the total amount of hours billed (excluding volumes deals) for TRCs by charging rate (if available) and the total direct cost per labour hour.*” Ofcom considers that “[t]his information would enable stakeholders to monitor the effectiveness of the proposed charge control and would also bring BT’s regulatory reporting requirements in line with these

in the fixed access markets as set out in the March 2015 Directions Statement.” (paragraph 8.19).

- *“BT must provide direct and indirect volume, revenue and cost information.” Ofcom considers that “[t]his is the same information provided for TRCs reported in the fixed access markets (currently AFI1B-2). The purpose of this information is to demonstrate the impact of [Ofcom’s] proposed requirement in relation to TRCs on actual revenue and profits. [Ofcom] need[s] to be able to assess to what degree BT continues to over or under recover its costs once charges are set, in order to assess whether [Ofcom’s] remedies are working as expected when [Ofcom] set them. This would also bring BT’s regulatory reporting requirements in line with those in the fixed access markets, as set out in the March 2015 Directions Statement.” (paragraph 8.22).*

170. As we set out in the August 2015 LLCC Response, we consider TRCs should not be regulated. Notwithstanding this fact, we set out below our comments on Ofcom’s above proposals:

- We agree with the requirement for reporting total fully allocated costs and revenues for all TRCs in the market summary for all BCMR markets in which the services are provided, in line with our reporting obligations in the fixed access markets where TRCs are currently subject to charge control (in line with paragraph 8.15).
- However, we do not agree with the additional proposed requirement to disclose the total amount of hours billed (excluding volumes deals) for TRCs by charging rate (if available) and the total direct cost per labour hour (included in paragraph 8.19). Ethernet TRCs currently use a manual process, and therefore it would be disproportionate in terms of the amount of work required to report the hours into normal, other, and Sunday/bank holiday hours.

It is unclear what purpose the additional requirement on TRC reporting is aiming to achieve. Should Ofcom maintain its proposal for TRC regulation, then there is no justification for the additional reporting requirement, which as outlined above would result in disproportionate additional burden, complexity and costs to Openreach.

- Finally, we are not clear what Ofcom envisages by the new requirement on BT to provide *“direct and indirect volume, revenue and cost information”* (included in paragraph 8.22). BT would appreciate further clarification by Ofcom. Moreover, we consider that whereas this information may be required for Ofcom to assess the effectiveness of their remedies and monitor BT’s compliance, there is no justification for requiring the information to be published

171. We would urge that this remains an AFI, confidential between Ofcom and Openreach. In this respect, as with Dark Fibre reporting, stakeholders should only be provided with revenues, volumes, and costs at the fully allocated level, and at the basket level – in this case total TRC – whereas the more detailed information requested (subject to our comments above) – should only be provided privately to Ofcom, to allow it to monitor effectiveness of the remedies and BT’s compliance.

Other issues

Price notification

172. Ofcom is proposing that the price reductions come into effect on 1 April 2016 and the charge control becomes effective at the same time and also that a 30 day notice of price reductions (and 90 days for price increases) is required.
173. Ofcom has waived notification with regard to the SCAs at paragraph 6.75. However, it makes no provisions for BT to implement the charge control on 1 April 2016 should the statement not be published in adequate time for BT to implement the first year price changes on 1 April compliant with the 30 day and 90 day notification obligation.
174. To enable BT to provide the required notice for price reductions to come into effect on 1 April 2016 would require BT to notify price changes by 1 March 2016 and for price increases 1 January 2016. As it is likely Ofcom will publish its final statement after 1 March 2016 but before 1 April 2016 it is imperative that Ofcom ensures the legal instrument allows BT to implement the proposed charge controls on 1 April 2016 without being non-compliant with a requirement to provide notice.
175. Similar issues has been dealt with in previous controls e.g. 2014 FAMR, by having different notification rules for the first year of the control. In this case, BT requests that price notification requirements for 1st year price reductions are explicitly waived in the final statement.

TI Sub Caps

176. In Annex 6 of the Consultation Ofcom has updated conditions 5D.1 and 5D.7 of the TI legal instrument to reflect the higher value of x (-3.5% within a range of +2.5% to -5.5%). However, Ofcom has not updated the sub-cap conditions 5D.3 and 5D.11. If these were to remain at the same level proposed by Ofcom in June LLCC consultation the sub-caps would be 0% if CPI is less than 5% and $CPI - 5\%$ where CPI is greater than 5%.
177. If the sub-caps remain unchanged there is a significant risk that the basket control will be driven by the sub-caps. This would happen if CPI were to increase above +3.5%, or if Ofcom concludes that the 'X' value for the charge control should be greater than 0%. As these values are within the consultation range, we consider that this is an oversight.
178. The sub-caps are not intended to be a more binding constraint than the overall basket control, but to restrict the extent to which BT could rebalance prices within the basket.
179. Given that in the June 2015 LLCC Consultation Ofcom proposed a sub-cap which was 7.25% above the proposed control, we suggest that Ofcom uses the same approach and apply a sub-cap of $CPI - X + 7.25\%$.
180. This would require that the sub-caps in sections 5D.3 and 5D.11 in Annex 6 of the November 2015 LLCC Consultation, are amended as follows:

5D.3 In the case of each of the services falling within the TI Services Basket, the Dominant Provider shall take all reasonable steps to secure that, on 1 April 2016, the Percentage Starting Charge Change in discrete charges for each and every service falling within the TI Services Basket is not greater than:

- i. ~~zero where CPI is less than or equal to 5 percentage points;~~
- ii. ~~CPI minus 5 percentage points where CPI is greater than 5 percentage points.~~

$CPI - X + 7.25\%$

5D.11 In the case of each of the services falling within the TI Services Basket, the Dominant Provider shall take all reasonable steps to secure that, at the end of each Relevant Year, the Percentage Change in discrete charges for each and every service falling within the TI Services Basket is not greater than:

~~i. zero where CPI is less than or equal to 5 percentage points; or~~

~~ii. CPI minus 5 percentage points where CPI is greater than 5 percentage points.~~

CPI - X + 7.25%