



**BT's response to Ofcom's Draft and Provisional Determinations and Conclusions to resolve disputes between BT and each of Sky, TalkTalk, Virgin Media, Cable & Wireless and Verizon regarding BT's charges for certain Ethernet services**

**Confidential  
(Confidential Information redacted)**

**20 April 2012**

## Executive Summary

- ES1. This Section summarises the main arguments in BT's response. These arguments fall into two main groups.
- ES2. First, leaving aside all legal issues, BT argues that Ofcom has nonetheless reached the wrong conclusion and in particular that:
- a. Some of the **cost adjustments** that Ofcom has made are correct but that others are not and that there are further adjustments that need to be made;
  - b. Ofcom was wrong to treat **connections and rentals** as separate services instead of being an upfront and recurrent tariff for a single service;
  - c. The **DSAC** numbers on which Ofcom has relied in its assessment of cost orientation were calculated incorrectly and do not provide BT with the appropriate degree of "*bounded flexibility*" to set prices that Ofcom has said previously is at the heart of its approach to cost orientation; and
  - d. Ofcom has applied the DSAC test mechanistically and without proper regard to the duration of any periods in which prices exceeded DSAC or any second order tests.
- ES3. Secondly, BT also argues that Ofcom has misinterpreted the law and in particular that:
- a. Ofcom has **misinterpreted the CAT's judgment** in the PPC case; and
  - b. The **CAT's judgment is itself wrong**, for the reasons set out in BT's appeal to the Court of Appeal.
- ES4. BT expands on these points in turn in the rest of this Executive Summary.

### Application of the PPC Case Principles

#### Cost Adjustments

- ES5. In these Disputes, BT accepts that Ofcom is right to adjust the published RFS numbers to correct for known errors. But clearly Ofcom must correct for errors that work in BT's favour as well as for those that count against BT if it is to reach a fair and balanced resolution of the disputes.

ES6. BT accepts that Ofcom has made the right adjustments in respect of:

- a. the following volume errors:
  - i. the discrepancy between the volumes used to derive component unit costs and those used to distribute component costs to services in calculating the 2006-07 and 2007-08 unit FACs and DSACs<sup>1</sup>;
  - ii. volume errors relating to WES services in 2006-07<sup>2</sup>;
  - iii. volume errors for BES1000 rental and BES1000 connection in 2008-09<sup>3</sup>; and
  - iv. the revenue errors associated with Main Link in 2008-09<sup>4</sup>;
- b. excess construction charges<sup>5</sup>;
- c. holding gains<sup>6</sup>;
- d. Regulatory Asset Valuation<sup>7</sup>; and
- e. Main Link rentals in 2006-07<sup>8</sup>.

ES7. This said, Ofcom was wrong in respect of other adjustments.

- a. Transmission equipment costs: it is a simple error not to include capital expenditure on transmission equipment costs in 2010-11; these costs were incurred to serve customers and should be reflected in any cost orientation assessment.
- b. 21CN costs: the 21CN and Ethernet services are closely related in that they meet the same customer need and the logical evolution path for buyers of Ethernet services is to their 21CN equivalent. Moreover, the DSAC methodology means that 21CN sunk costs would not be taken into account in any future assessment of cost orientation so that 21CN costs would never be considered in any assessment of cost orientation.

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<sup>1</sup> E1DD §§12.43 to 12.45

<sup>2</sup> E1DD §§12.46 to 12.48

<sup>3</sup> E1DD §§12.49 to 12.54

<sup>4</sup> E1DD §§12.55 to 12.56

<sup>5</sup> E1DD §§12.79, 12.80

<sup>6</sup> E1DD §§12.85 to 12.96

<sup>7</sup> E1DD §§12.97 to 12.100

<sup>8</sup> E1DD §§12.101 to 12.107

- c. Payment Terms: The assessment of overcharging should be based on the days' credit actually taken by the CPs not the credit they were supposed to take, otherwise they would be rewarded twice for being delinquent in their payments – once by taking extra credit and then again through receiving an increased payment as part of the dispute resolution settlement.

ES8. Other adjustments are also needed.

- a. BES Fibre Costs: These were understated in the RFS in 2006-07 and 2008-09 as a result of an error in the calculation of the number of BES fibre circuits (there are two ends for each BES circuit but the RFS was calculated as if BES were WES with only one end).
- b. Provisioning Costs: These costs were excluded from the RFS for the years 2005-06 to 2007-08 inclusive as a result of errors in the mapping of cost components to services (and then overstated in 2009-10).
- c. ISDN2 Monitoring Lines: ISDN2 lines are used to monitor certain WES and BES services for faults. The ISDN2 monitoring line is for the provision of providing WES and BES to multiple customers and therefore is a supply cost. The cost should therefore be reflected in the Ethernet costs but as a result of an oversight this was not done in the RFS.

ES9. Finally BT believes that it is possible to derive a more accurate proxy for the costs of other bandwidths than that used by Ofcom by allowing for the fact that while many costs (such as fibre) are bandwidth independent, electronic costs do vary with bandwidth.

### **Connections and Rentals**

ES10. Ofcom's decision to treat connections and rentals as if they were separate and distinct services, when it conducted its first order testing, rests on many misunderstandings and a misapplication of the CAT's comments in the PPC Judgment to the facts of the present Disputes.

ES11. At its heart is a misunderstanding of the nature of the services that the CPs are buying from Openreach. The CPs are buying "network access" that is to say they are buying the right to send data at various defined speeds between two defined points on Openreach's network

and they gain this access by agreeing to pay both connection and rental charges; paying just a connection charge or just a rental charge does not give a CP any right whatsoever to access Openreach's network.

- ES12. There is no parallel with the CAT's judgment in the PPC case. The CAT was considering the correct treatment of services that differ in their technical characteristics (i.e. they run at different speeds and over different parts of the network). In this response BT does not challenge Ofcom's decision, when conducting its first order testing, not to aggregate Ethernet services that are similar to those considered by the CAT so that, for the purposes of these Disputes, BT is not arguing for the aggregation of different bandwidths, or Main Link and other services, or BES and WES. But there are no such technical differences between connections and rentals – there is rather a single service for which both a connection charge and a rental charge are published.
- ES13. Ofcom has further misunderstood how customers are affected by connection and rental charges. It presented an analysis based on a one year snap shot of the amount paid by different customers that purported to show that different customers differ greatly in the proportion of their payments that are represented by connection and rental charges. This analysis was flawed because it considered only the payments in any one year. The differences shown between customers were largely a product of the different stages they had reached in rolling out their networks (customers still rolling out their networks were not surprisingly paying proportionately more in connection charges than those that had built out their networks earlier).
- ES14. BT has therefore undertaken a "decay analysis" that considers the lives of circuits from the date they were installed and this clearly shows that for any given circuit type there are, for the most part, only small differences between CPs in terms of the average lives of the circuits they have bought from Openreach. BT does not claim that there are no differences whatsoever between CPs but it must be borne in mind that the cost orientation obligation on BT applies to *each and every price for each and every service* and not to each and every price for each and every service for each and every customer and that it is a normal feature of competitive markets that, even considering individual services, businesses earn higher margins on serving some customers than on others. There is no evidence that the relative pricing of connections and rentals has systematically advantaged or disadvantaged any CP.

ES15. Further, Ofcom has misunderstood other factors.

- a. Best accounting practice: The International Accounting Standards Board (IASB) has published an Exposure Draft that would require businesses to account for connections and rentals as parts of a charge for a single service and not as separate and distinct charges for separate services.
- b. Normal commercial practice: no rational buyer would ever base a purchase decision on an upfront charge alone without also considering recurrent charges; likewise no seller would ever set an upfront charge independently of recurring charges.
- c. The nature of the costs incurred in providing Ethernet services: electronics costs make up the bulk of the direct costs and it is largely a matter of subjective judgement whether these are attributed to connections or rentals (whereas in the PPC case there were clear objective grounds for attributing costs to the different services).
- d. The significance of the price list: the publication of both connection and rental charges does not prove they are separate services - both parts of a two-part tariff also have to be published.

ES16. Finally Ofcom's decision to treat connections and rentals separately is inconsistent with its own past behaviour. Indeed in considering starting charge adjustments for the LLCC, Ofcom very neatly expressed the case for considering connections and rentals together.

*"We explained that in considering possible start charge adjustments, we had looked at BT's rental and connection costs (for each BES and WES service) together, as those charging elements fall in the same economic market; BT's wholesale customers would necessarily consume them together; and it is not always clear what the optimal structure of charges is, and what the balance should be between up front (connection) and recurring (rental) elements for efficient recovery of costs."*<sup>9</sup>

### Correct Calculation of DSAC

ES17. There is an error in the published DSACs that means that they are not fit for the purpose of assessing cost orientation. In any event it is wrong for Ofcom to ignore plainly relevant

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<sup>9</sup> E1DD §8.64

evidence which shows that the figures Ofcom used are most certainly not definitive. BT should not be denied the opportunity to demonstrate compliance by Ofcom rejecting out of hand evidence that clearly supports BT's case.

ES18. That there is an error is obvious on the face of the numbers. It would normally be expected that LRIC < DLRIC < FAC < DSAC < SAC but in this case:

- a. at the product level, one DSAC is below FAC and others are only a little above FAC; and, tellingly,
- b. for some cost categories, the value of the asset included in the DSACs is significantly below (and in some cases under half) the value of the duct included in the FACs.

ES19. BT investigated why these results were so odd and discovered that the model had been set up so that costs that were specific to local duct and fibre (".l") were being attributed in large part to core (".c") activities. It was an error pure and simple - just as much of an error as those for which Ofcom has adjusted, albeit with an even greater impact. This error has now been corrected and from 2011-12 onwards the RFS has been calculated on the alternative correct method put forward by BT (and accepted by Ofcom after appropriate consultation). The corrected numbers put forward by BT were calculated using this correct methodology and ought to have been adopted by Ofcom for the purposes of resolving this dispute.

ES20. Because the published numbers are wrong they do not serve the stated purpose of Ofcom's approach to cost orientation of giving BT the intended degree of "*bounded flexibility*" over how it recovers its costs.

ES21. Consistent with Ofcom's policy, Mr Myers stated in his PPC witness statement that:

*"The DSAC approach, therefore, still provides for substantial (but bounded) pricing flexibility. The flexibility on 2Mbit/s trunk pricing was as follows: a. DSACs for 2Mbit/s trunk services were about 75% to 120% higher than FAC and, on average, 85% higher (...). That is, the DSAC approach allowed BT to increase the prices and the recovery of common costs from 2Mbit/s trunk services by a very substantial amount over and above the allowance already included in FAC."*<sup>10</sup>

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<sup>10</sup> CAT Case No. 1146/3/3/09, Witness Statement of Geoffrey Richard Platt Myers, paragraph 37

- ES22. It cannot then follow that DSAC should be imposed as a price ceiling when this would not allow BT to recover even the level of common costs included in FAC, or when it would allow BT to recover only an amount marginally above FAC. Here it is instructive to compare the “*bounded flexibility*” allowed in the PPC case where, as seen above, this permitted prices which were 85% higher than FAC. This contrasts with the present case where, for example, in 2006-07, DSAC is just 113% of FAC and actually below 100% in the case of BES 10 rental. Likewise the ROCE permitted by setting prices equal to DSAC in the PPC case was 54% over the dispute period but only 23% in the Ethernet case.
- ES23. The difference between the two cases has not been because of a deliberate choice by Ofcom to apply a different policy for Ethernet than for PPCs. Indeed Ofcom has made it clear that it is trying to take the same policy approach. It is rather the case that because the original published DSACs were wrongly calculated they are not fit for the purposes of assessing cost orientation applying the principles set out in the PPC Judgment.
- ES24. The reasons Ofcom gives for nevertheless using the original incorrect figures are flimsy.
- a. Ofcom speculates that the problem might have arisen because of inconsistency between the models used to produce the FAC and DSAC numbers (“*If, for example, BT had derived both FAC and DSAC on the basis of a consistent set of models, we would expect DSACs always to be greater than or equal to FAC.*”<sup>11</sup>). Here Ofcom is simply mistaken. There are no inconsistencies as the LRICs and hence DSACs are derived from the FACs and not produced through independent systems.
  - b. Ofcom states that it will only make corrections where “*the methodology... is obviously inappropriate or if there are mathematical, input or software errors*”<sup>12</sup>. This is the case here. The methodology is inappropriate in that, for the same FAC value, it leads to roughly eight times as much FCC being allocated to certain components within the Core Increment as to others. It is a mathematical error to use the wrong formula to calculate a desired result – it is not possible to calculate the area of a circle by multiplying its diameter by  $\pi$  even if the arithmetic is faultless.

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<sup>11</sup> E1DD §11.51

<sup>12</sup> E1DD §11.34



- c. Ofcom states that one of its reasons for not adopting the corrected methodology is that this would “create poor incentives”<sup>13</sup> for BT to get its methodology right. This is an ill-considered suggestion. Ofcom ought not to be effectively fining BT multi-million pound sums for having made an error in the published accounts – it has other powers it could and should use for such a purpose.

ES25. It might be said that the errors in the published numbers should have been discovered earlier. Clearly it would have been better had they been but they were not. In truth the calculation of the DSACs received too little attention by BT and others until the rash of disputes made their significance clear. This said this is no reason not to use the corrected numbers just as it is right to correct for other errors in the published RFS. The revised numbers put forward by BT are fit for Ofcom’s purposes. The original published numbers are not.

#### Duration and Second Order Tests

ES26. Ofcom has applied the DSAC test mechanistically as if it alone were determinative of cost orientation even though the CAT in the PPC Judgment stressed the need for Ofcom to be cautious in using retrospective data to assess cost orientation<sup>14</sup> and Ofcom itself had indicated in the PPC Final Determination<sup>15</sup> that it would only regard BT’s prices as breaching the cost orientation obligation if they were persistently above DSAC or there were specific circumstances warranting a finding of a breach (and mentioned as relevant circumstances the number of the financial years in which charges exceed the DSAC, the magnitude of the excess in each of those years, the trend, and average charges compared to DSAC across the whole period). Yet in the draft determination, notwithstanding this guidance, Ofcom has found BT to be in breach in respect of:

- a. WES 10 rentals for a single year, namely 2008-09;
- b. BES 1000 connections for a single year, namely 2006-07;

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<sup>13</sup> E1DD §1.19.3

<sup>14</sup> PPC Judgment §§ 298 – 299: “In particular, Ofcom must have regard to the fact that whereas the regulated company is *prospectively* seeking to comply with the condition, Ofcom is *retrospectively* assessing whether there has been compliance. It may be quite difficult for a regulated firm in the position of BT to ensure that its prices meet its cost orientation obligation, even if it has the firmest intentions of doing so”.

<sup>15</sup> PPC1 Final Determination §§ 5.93 to 5.96

- c. BES 100 connections, where the charge was in excess of DSAC for only two years (namely 2006-07 and 2007-08); and
- d. more generally, circuits supplied in 2006-07 when Openreach was still gearing up to meet an unexpectedly rapid increase in demand for what were largely new services whose costs were not yet fully understood.

ES27. Ofcom has taken a highly restrictive approach on DSAC generally, which fails to acknowledge that it is a first order test, and that the features of the market generally should be taken into account when considering the broader question of compliance with the cost orientation obligation.

### Impact

ES28. The Table below shows what would be BT's liability to make repayments after making the cost adjustments described above, treating connections and rentals as two parts of a charge for one service and correcting the error in the methodology used to produce the published DSACs.

#### Repayments after making required corrections [C]

Repayments £ m	06-07	07-08	08-09	09-10	10-11
BES 100	[N/A	■	N/A	N/A	N/A
BES 1000	■	■	■	N/A	N/A
WES 10	NiD	NiD	N/A	NiD	NiD
WES 100	N/A	N/A	N/A	N/A	N/A
WES 1000	N/A	N/A	■	N/A	N/A
Main link	NiD	NiD	■	NiD	NiD
BES 155	■	■	■	■	■
BES 622	■	■	■	■	■
BES 2500	NiD	NiD	N/A	NiD	NiD
BES 10000	NiD	NiD	N/A	NiD	NiD
WES 155	■	■	■	■	■
WES 622	■	■	■	■	■
WES 10000	NiD	N/A	N/A	NiD	NiD
<b>Total repayment by year</b>	■	■	■	■	■
<b>Total repayment</b>					■

**Table EX 1**

ES29. Further, the table below shows the amounts which BT would be required to re-pay to resolve the Disputes if Ofcom were to decide that charges had to exceed DSAC for more than one or more than two successive years. The numbers are calculated on both Ofcom's

original numbers and on the revised numbers after allowing for the additional cost adjustments, treating connections and rentals as parts of the charge for a single service and adopting the corrected DSAC methodology.

£M	Successive Years In Which Charges Exceed DSAC	
	More Than One	More Than Two
Ofcom's Numbers	134.4	124.7
Corrected Numbers	[REDACTED]	[REDACTED]

**Table EX 2 [C]**

ES30. Eliminating the repayments in respect of 2006-07 to recognise the high degree of uncertainty surrounding BT's costs in the early years of the Ethernet market would reduce the total repayment by £35.7m using Ofcom's original numbers and [REDACTED]m[C] using BT's corrected figures.

ES31. These points are without prejudice to BT's broader contentions that Ofcom's approach is wrong and that accordingly no monies should be ordered to be repaid under s.190(2)(d).

## Legal Issues

ES32. As set out above BT considers that:

- a. Ofcom has failed to appreciate the uncertainty which BT faced, and has also misinterpreted the CAT's PPC Judgment; and
- b. The CAT itself made errors in its judgment.

ES33. Both points are developed in turn.

## Failure to Appreciate the Uncertainty Faced by BT and Misinterpretation of CAT's PPC Judgment

ES34. In its submission of 20 May 2011 BT described the close contact and the very many meetings which BT had with Ofcom during the relevant period and particularly between 2006 and the beginning of 2008 about the Ethernet portfolio and pricing<sup>16</sup>. In the Draft Determination Ofcom classified these arguments exclusively as "legitimate expectation"

<sup>16</sup> 20 May Response §§43-48

arguments<sup>17</sup>. Ofcom then proceeded to reject the arguments solely on the grounds relating to the legal conditions for establishing a legitimate expectation. In doing so, Ofcom has failed to take into account the uncertainty and lack of transparency faced by BT:

- a. it was never explained by Ofcom, nor appreciated by BT, that cost orientation would be assessed using a test with very rigid parameters (and nor could the CPs buying the relevant services have appreciated this either); and
- b. had this been appreciated by BT at the time, it is more than likely that BT would either have adjusted its charges (including charges for services other than the disputed WES and BES charges), or discussed relaxation of the obligation or sought a direction that the obligation did not apply.

ES35. Ofcom was and is under a duty to make its policy as regards cost orientation clear. This follows from its obligations under UK national law and the CRF to be transparent, accountable and proportionate.

ES36. In the present case, Ofcom never made clear to BT, at the time when BT was setting the prices which are the subject of the present disputes and was still therefore able to re-organise its prices that BT would be expected to be able provide a separate justification for each and every price in the price list. Connections and rentals are a good example in that, as demonstrated above and below, Ofcom itself acted as if it were right to consider these two charges together but has now taken a quite different approach in resolving these disputes.

ES37. The following points should also be noted.

- a. Condition HH3.1 does not spell out any of Ofcom's policies in relation to any of the matters identified in the previous section – it does not even refer to DSAC but it does make it clear that there is intended to be a degree of flexibility, flexibility that is not available if cost orientation is assessed using the original published incorrect figures.
- b. Like Condition HH3.1, the 2004 LLMR which it formed a part of, did not explain how the cost orientation obligation was to be applied. Such indications as there were suggested that there would be latitude arising from the fact that Ofcom recognised that the AISBO market was a nascent market.

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<sup>17</sup> E1DD §10.52

- c. The 1997 and 2001 Guidelines are obviously relevant. However, they provide only limited further detail for Ofcom's policies as to the application of cost orientation in the Ethernet market, but such detail as there was suggested that Ofcom would be prepared to examine the market in question and take a flexible effects based approach, including an investigation of the economic impact of the pricing concerned.
- d. Ofcom has misunderstood the nature of the CAT PPC Judgment. It was an appeal confined to the specific points raised in BT's Notice of Appeal to the CAT in that case. Moreover, the PPC Judgment makes clear: (a) the problems facing BT in seeking *ex ante* to comply with the obligation when Ofcom only looks at the issue *ex post*<sup>18</sup>; (b) there is an inherent flexibility in how BT can demonstrate compliance<sup>19</sup>; and (c) DSAC was not a conclusive indicator that costs had been appropriately allocated and that charges in excess of DSAC could still be cost orientated.<sup>20</sup>

### Errors in CAT Judgment

ES38. BT in any event contends that the decision contained in the CAT's PPC Judgment was flawed. These points have been more fully set out in BT's Ethernet Historic Charges Dispute response document of 20 May 2011 ("the May 2011 Response") and BT's Skeleton Argument and Application for Permission to Appeal to the Court of Appeal (dated 24 June 2011 and referred to as "the Court of Appeal Skeleton"), copies of which Ofcom already obviously possesses.

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<sup>18</sup> See e.g. CAT PPC Judgment §§ 298, 299, 303 and 304

<sup>19</sup> See e.g. CAT PPC Judgment § 249(1)

<sup>20</sup> See e.g. CAT PPC Judgment § 285

## Conclusion

ES39. BT's argument in a nutshell<sup>21</sup> therefore is that:

- a. Ofcom's approach to the assessment of cost orientation is now quite different from that which BT had been led to expect by Ofcom; at the very least Ofcom must take its past guidance into account when applying second order tests;
- b. this said, even adopting the principles set out in the draft determination, Ofcom has over-estimated the amount that BT should pay the disputing CPs; Ofcom needs to make further cost adjustments, treat connections and rentals as different parts of a charge for a single service and adopt the revised DSAC methodology; and
- c. Ofcom has incorrectly applied the PPC Judgment in this case but in any event the CAT's interpretation of the law as set out in the PPC Judgment is wrong for the reasons set out in BT's appeal.

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<sup>21</sup> and without prejudice to BT's Skeleton Argument and the full and additional argument set out therein.

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# 1 Introduction

## 1.1 Introduction

1. This document sets out British Telecommunications plc (“BT”<sup>22</sup>)’s response to three Ofcom draft and provisional determinations and conclusions:

1.1. “Disputes between each of Sky, TalkTalk and Virgin Media regarding BT’s charges for Ethernet services” (“the Ethernet 1 Dispute”) – Draft Determinations and Explanatory Statement, published 9 February 2012 (“the Draft Determinations” or “the E1DD”);

1.2. “Dispute between Cable & Wireless and BT about BT’s charges for Ethernet services” (“the Ethernet 2 Dispute”) – Provisional Determination, issued 23 February 2012 (“the Provisional Determination” or “E2PD”); and

1.3. “Dispute between Verizon and BT relating to BT’s charges for WES” (“the Ethernet 3 Dispute”) – Provisional Conclusions, issued 4 April 2012 (“the Provisional Conclusions” or “the E3PC”);

(together “the Disputes”).

2. A separate document sets out BT’s response to Ofcom’s associated draft determination to resolve disputes between each of Cable & Wireless, Global Crossing, Verizon, Virgin Media and COLT and BT regarding BT’s charges for partial private circuits (“PPC Disputes”) – Draft Determinations and Explanatory Statement, published 9 February 2012 (“the PPC2 Draft Determination” or “the PPC2 PD”).

## 1.2 Structure of this response

3. Unless the context or the text indicates otherwise, this response focuses on the Ethernet 1 Draft Determinations, these Draft Determinations being the basis for the Ethernet 2 Provisional Determination and the Ethernet 3 Provisional Conclusions.

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<sup>22</sup> BT is a wholly owned subsidiary of BT Group plc providing communications, IT and related services and products in the UK. Further information about BT and BT Group plc can be found in the BT Group Annual Report 2011 at: <http://www.btplc.com/Sharesandperformance/Annualreportandreview/Annualreports/AnnualReports.htm>

4. This response, building on BT's response of 20 May 2011 ("the 20 May Response"), will explain why Ofcom's dispute resolution proposals are wrong. BT will approach this task in two ways: in Sections 2 to 9, BT will assume, without prejudice to BT's appeal to the Court of Appeal, that the Competition Appeal Tribunal ("the CAT")'s PPC Judgment<sup>23</sup> is correct in law; and in Section 10, BT relaxes the assumption made for the purpose of the earlier Sections and deals with issues that would arise should that judgment be set aside as a result of BT's second appeal.
5. Sections 2 to 10 discuss the following:
  - 5.1. Section 2: sets out some overarching points relating to Ofcom's duties and the approach to this case, including the actual effect of the CAT's PPC Judgment (these points were briefly touched upon in the Executive Summary at §§ ES12, ES26 and ES34).
  - 5.2. Section 3: sets out the background and historical context that it is necessary to consider to properly dispose of these disputes (again, these points were briefly touched upon in the Executive Summary at §§ ES16, ES27 and ES34 to ES37).
  - 5.3. Section 4: deals with cost adjustments and proxies. The section explains why: (i) a number of Ofcom's proposed cost adjustments are wrong; (ii) identifies a number of additional adjustments that should be made; and (iii) sets out a clearly superior method for calculating proxy costs for those bandwidths not separately reported in BT's Regulatory Financial Statements ("the RFS"). (BT's central arguments in relation to cost adjustments and proxies were very briefly summarised at §§ ES5 to ES9 in the Executive Summary).
  - 5.4. Section 5: deals with the correct treatment of connections and rentals and explains why, in deciding to treat connections and rentals as separate and distinct services, rather than as an upfront and on-going charge for a single service, Ofcom has misinterpreted and consequentially misapplied the PPC Judgment to its assessment of BT's compliance with Condition HH3.1. The section also explains why Ofcom's approach is: (i) based on faulty analysis of customer purchasing patterns; (ii) inconsistent with normal commercial practice; (iii) inconsistent with best accounting practice; and (iv) inconsistent with Ofcom's previous regulatory

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<sup>23</sup> [2011] CAT 5

guidance. (BT's central arguments in this regard were very briefly summarised at §§ ES10 to ES16 in the Executive Summary).

- 5.5. Section 6: deals with DSAC methodology errors. The section explains why BT's published historic DSACs (2006-07 to 2009-10 inclusive) are not fit for the purpose of assessing compliance with Condition HH3.1 and resolving these disputes. In the case of the Alternative Interface Symmetric Broadband Origination ("AISBO") market, the published DSACs do give BT the "*bounded flexibility*" to set charges and recover cost – flexibility that is at the heart of both: (i) Ofcom's regulatory policy on cost orientation; and (ii) the underlying economic theory of cost orientation. The published DSAC numbers are simply wrong: the numbers reflect the sharing of costs for assets specific to certain activities with other activities for which these assets are not used. (BT's central arguments on the correct calculation of DSAC were very briefly summarised at §§ ES17 to ES25 in the Executive Summary).
- 5.6. Section 7: deals with a specific part of the incorrect approach Ofcom has adopted in proposing to find breaches of cost orientation or ordering repayments. In particular, BT considers the instances when Ofcom has been prepared to find a breach of Condition HH3 even when BT has not been persistently above DSAC throughout the period. Such an approach is inconsistent with Ofcom's previous approach and the conclusions of the CAT's PPC Judgment. (These points were briefly touched upon in the Executive Summary at § ES26).
- 5.7. Section 8: deals with the proper approach to cost orientation in the specific circumstances of this market and in particular that Ethernet was a nascent market with inherent uncertainties. (These points were briefly touched upon in the Executive Summary at §§ ES26 and ES33 to 37).
- 5.8. Section 9: provides the overall assessment of the amount which BT might be deemed to have over-charged for BES and WES services. It shows the impact of the various changes to Ofcom's methodology identified in Sections 4, 5, 6 and 7, both collectively and individually. This section explains why, assuming the PPC Judgment is good law, BT's maximum liability is very much less than that Ofcom has provisionally calculated. (These points were briefly touched upon in the Executive Summary at §§ ES28 to 31).

- 5.9. Section 10: very briefly summarises BT's arguments as to why the CAT's Judgment in the PPC case is wrong in law. The arguments here are effectively those raised in BT's appeal to the Court of Appeal. (These points were briefly referred to in the Executive Summary at § ES38).

## 2. Ofcom's Duties and Proposed Approach

### 2.1 Introduction

6. BT has always strived to understand and comply with all regulatory conditions and obligations imposed upon it. The regulation of telecommunications is complex, with competing and sometimes contradictory obligations. The regulatory environment is constantly evolving. What is required to comply is not always clear. Telecommunications markets evolve and change rapidly. Within this regulatory and commercial environment BT must plot a course that fairly serves its investors, customers and other stakeholders, whilst not unfairly restricting competition or harming consumers. In this case, this is not, and was not, an easy task.
7. Ofcom's proposed approach is to take a 'snapshot' of regulation as it views it today and to apply this snapshot to BT's past charging behaviour, to a great extent ignoring the regulatory and commercial environment that existed at the time each disputed charge was set.
8. Ofcom has set out a limited history of BT's cost orientation obligations, BT's regulatory reporting obligations and BT's LRIC model<sup>24</sup>, and of BT's Ethernet products and particularly WES and BES<sup>25</sup> in the Draft Determinations. But these brief sections provide little insight into the regulatory and commercial environment that prevailed during the relevant periods.
9. The Draft Determinations ignore the very positive contribution that BT's successful development, launch and continued supply of Ethernet services has had on the UK's telecommunications market. The UK now has one of the most competitive markets in the world and the BES and WES services played a vital part in the very successful implementation of Local Loop Unbundling ("LLU") in the UK and the resulting thriving retail broadband, calls and lines markets. The benefits of these thriving markets have been shared by the disputing CPs (Sky, TalkTalk, Virgin Media, Cable & Wireless and Verizon – together the "Disputing CPs") and by their customers, as well as other UK consumers.
10. Ignoring these historical regulatory and commercial environmental factors, as well as many other factors, has led Ofcom to propose a wrong-headed view of cost orientation and how

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<sup>24</sup> E1DD §4

<sup>25</sup> E1DD §6

compliance with Condition HH3.1 should be measured and tested. Ofcom's Draft Determinations are not only unreasonable, but also wrong: in law, in economics, and in terms of Ofcom's stated regulatory policy.

11. Ofcom seems to have made every possible assumption against BT's position. For example, Ofcom is proposing to draw conclusions against BT on issues, e.g. the use of proxies<sup>26</sup>, where BT's regulatory financial statements ("the RFS") are insufficiently detailed and BT therefore holds insufficient data, particularly in the early years of the development of the Ethernet market; the content of which statements were stipulated by Ofcom.
12. Ofcom highlights "BT *will however retain data at service level and make this available to Ofcom*"<sup>27</sup><sup>28</sup> to support its contention that, notwithstanding the "*reduc[ing] ... regulatory burden on BT*", that BT was nonetheless required to keep data and have this available. Ofcom goes on to comment that:

*"The fact that BT is not required to publish the information to demonstrate this in the RFS does not mean it need not be able to provide it if required. As such, in our view BT cannot infer from the aggregated approach to the financial reporting that was permitted, particularly in the early years of the Relevant period, that an aggregate approach to cost orientation is appropriate."*

13. Although Ofcom references, in footnote 102 of the E1DD, the name of the document from which the above quote is taken, what Ofcom does not make clear is that that document was a consultation document and that the requirement "*to retain data at service level and make this available to Ofcom*" did not continue through into the resulting statement and Ofcom has not imposed on BT an obligation to have available information at a more granular level than that required to be published in the RFS.
14. Overall, Ofcom proposes to depart from what was effectively a shared (historical) understanding of the approach which would be taken to cost orientation and the assessment of compliance with basis of charges type conditions, such as Condition HH3.1. This is particularly stark in respect of the way Ofcom now seeks to treat connections and rentals as separate and distinct services and not as two aspects of the charge for a single service.

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<sup>26</sup> E2PD §5.39

<sup>27</sup> Paragraph 6.8 of "Proposed changes to BT's regulatory financial reporting framework" – Regulatory reporting May 2005

<sup>28</sup> E1DD §8.42



15. The Draft Determinations, whilst acknowledging this previous understanding, particularly in respect of connections and rentals and duration, sidesteps Ofcom's previous practice. This is illustrated by the 2009 Leased Lines Charges Control ("the 2009 LLCC") where, for example:
- 15.1. both Ofcom and BT had worked for a number of years on the assumption that it would be correct to measure compliance by combining connection and rental prices to give the charge to which the basis of charges condition applied at a particular bandwidth;
  - 15.2. Ofcom considered that it would be disproportionate to require detailed RFS reporting;
  - 15.3. as Ofcom considered it would be disproportionate to require detailed RFS reporting, it must follow that Ofcom also considered it disproportionate to have required the same detailed exercise to be carried out in relation to cost orientation and as regards assessing and justifying compliance with Condition HH3.1; and
  - 15.4. as recently as 2010, and after the PPC Judgment, Ofcom was still adopting the position that it would be correct to combine connection and rental prices to give the appropriate charge, and that this was therefore a different issue to the aggregation issue presented by 2Mbit/s PPC Trunk segments and Terminating segments in the PPC 1 Dispute<sup>29</sup> and PPC Judgment.
16. Ofcom's proposed approach to cost orientation and assessment of compliance with basis of charges conditions, specifically Condition HH3.1, departs from this shared understanding with retrospective effect. Whilst Ofcom may alter its approach and regulatory policy to adapt to the changing regulatory and commercial environment, it is wrong for Ofcom to apply this altered approach retrospectively. Clearly a retrospective change to regulation gives BT no opportunity to alter its charges to ensure compliance with that altered approach and still meet the demands of its investors, customers, and other stakeholders across its product base, in this case, specifically the Openreach products.
17. During the relevant period BT was not aware of the obligations that would be imposed upon it, and neither was Ofcom. This is clear from Ofcom's Gareth Davies' letter of 6 December 2010 ("the 6 December letter"); the full text of this letter is set out in Annex A.

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<sup>29</sup> Disputes between each of Cable and Wireless, THUS, Global Crossing, Verizon, Virgin Media and COLT and BT regarding BT's charges for 2Mbit/s partial private circuits trunk segments

18. In December 2010, Ofcom clearly regarded a different approach, to the one it is now proposing to take, as entirely legitimate. Ofcom does not suggest that the approach it took in the 2009 LLCC was wrong. If Ofcom’s 2009 LLCC approach is legitimate and BT has flexibility as to how to comply with Condition HH3.1, Ofcom’s approach in the Draft Determinations must be wrong.
19. The wording of Condition HH3.1 cannot override the effect of the market context. Ofcom is proposing to interpret Condition HH3.1 too inflexibly.

## 2.2 Transparency, consistency, proportionality and legal certainty

### 2.2.1 Introduction

20. In the 20 May Response BT outlined a number of factors on which it relied to contend that it would not be appropriate to require BT to make payments to the Disputing CPs. Without setting those matters out in detail again, they included:
  - 20.1. the close contact and the very many meetings which BT had with Ofcom during the relevant period, and particularly between 2006 and the beginning of 2008, about BT’s Ethernet portfolio and its pricing<sup>30</sup>;
  - 20.2. Ofcom’s response to the Thus complaint and to the material supplied by BT in response to Ofcom’s s.135 request in 2007<sup>31</sup>; and
  - 20.3. the fact that Ofcom had previously recognised the existence of a link between connections and rentals for Ethernet in §5.8 of the 2009 Leased Lines Charge Control (“the 2009 LLCC”) and in the 6 December Letter<sup>32</sup>.
21. In the Draft Determinations Ofcom classifies these arguments exclusively as “legitimate expectation” arguments<sup>33</sup>. Ofcom then proposes to reject the arguments solely on the grounds relating to the legal conditions for establishing a legitimate expectation. In doing so, Ofcom fails to acknowledge that there are a number of other considerations, quite separate from the question of whether any legitimate expectation arises, arising from the

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<sup>30</sup> 20 May Response §§43-48

<sup>31</sup> Ibid. §§49-55

<sup>32</sup> Ibid. §71 and fn. 32

<sup>33</sup> E1DD §10.52

same facts and relating to the way in which Ofcom proposes to exercise its statutory powers in these Disputes. These other considerations are dealt with below.

22. There are a number of aspects of Ofcom's proposed approach to the interpretation and proposed application of Condition HH3.1, aspects which Ofcom never made clear to BT until after the periods affected by its proposed determinations. If Ofcom nevertheless applies that approach in its final determinations of these Disputes, Ofcom will be acting contrary to its duties as regulator, including the requirements of transparency, consistency, acting in a proportionate manner and respecting the requirements of legal certainty. To this end BT:

22.1. makes a few general comments on Ofcom's approach (Section 2.2.2);

22.2. elaborates on why it contends that Ofcom was and is under a duty to have made certain matters clear to BT in advance of BT setting its charges, so that BT could adjust its position accordingly (Section 2.2.3);

22.3. outlines those aspects of Ofcom's approach that, critically, it was never informed of, but which it should have been told about if Ofcom intended to apply Condition HH3.1 in the manner now being proposed in the Draft and Provisional Determinations and Conclusions (Section 3.2.2); and

22.4. demonstrates that it was not told of these aspects of Ofcom's policy (Section 3.4.1).

### 2.2.2 General comments

23. BT is not contending that Condition HH3.1 had no effect at all; it clearly did. BT accepts (as is plain) that Condition HH3.1 placed BT under an obligation to ensure that its charges for network access were reasonably derived from its costs. BT is not saying, therefore, that the lack of specificity in Condition HH3.1, or in Ofcom's policy documents, prevents any cost orientation obligation from arising or being applied.

24. Nor is BT saying that Ofcom is required to issue guidelines and policy statements which anticipate every possible situation and prescribe the approach it will take. It is plain that guidelines must not fetter the decision of a regulator<sup>34</sup>, and that their contents can be departed from where appropriate on condition that reasons for that departure are given.

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<sup>34</sup> See for example the CAT's comments in *British Telecommunications Plc v Ofcom* [2011] CAT 24 at §209.

Policies must not be so rigid as to exclude consideration of the proportionality of the result. Lastly, BT also accepts for the purposes of these Disputes (although without prejudice to the arguments relied on in its appeals of the PPC Judgment and the PPC Preliminary Judgment<sup>35</sup>) that:

- 24.1. Ofcom is entitled to use some form of accounting test as a “first [order] test” in order to examine whether or not charges were reasonably derived from costs when assessing compliance with Condition HH3.1; and
  - 24.2. of the various possible accounting tests that Ofcom could have used, DSAC (with appropriate adjustments, flexibility applied in a non-mechanistic way) is an appropriate first order test to use.
25. BT is keen to stress all the points made above in order to avoid any misunderstanding from arising: Ofcom should not regard BT as arguing that it was not subject to any cost orientation obligation at all. That is certainly not BT’s purpose in raising the points made in this sub-section 2.2.
26. Instead, BT is concerned to ensure that a cost orientation test with very rigid parameters is not applied to it when it would be unfair to do so. In broad terms, to apply such a test would be unjust and disproportionate and of retroactive effect in circumstances where the parameters of such a test, and its effects as regards the Ethernet market, were (quite reasonably) never appreciated by BT, nor explained to BT contemporaneously by Ofcom, even though Ofcom had ample opportunity to make its approach clear. Further, the Disputing CPs cannot rely on the fact that Condition HH3.1 would be interpreted in the way Ofcom seeks to interpret it in relations to BES and WES services, since for the reasons explained in this sub-section, the parameters set out above had never been made clear by Ofcom to BT or to those purchasing BES and WES, including the Disputing CPs.
27. Had those parameters been appreciated by BT at the time, it is more than likely that BT would either have adjusted its charges (including charges (and prices forming those charges) for services other than the disputed WES and BES charges), or discussed with Ofcom the relaxation of the obligation or sought a direction that the obligation did not apply. BT, of course, had no wish to flout the obligation for its charges to be cost orientated or to fail to comply with Condition HH3.1. It would have sought to comply with

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<sup>35</sup> [2010] CAT 15

it prospectively, in the way now proposed by Ofcom, had it known what this was (or else sought relaxation from it, or pursued a challenge if that was considered appropriate).

### 2.2.3 Ofcom's duty to make its policy clear

28. Ofcom was under a duty, in the circumstances of these Disputes, to make its policy as regards the parameters of cost orientation and compliance with Condition HH3.1 clear. That duty flows from Ofcom's obligations:

28.1. to act in a manner which was transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, and to follow regulatory best practice; and

28.2. to ensure that the obligations which are placed on CPs (including BT) are sufficiently clearly stated so that those CPs know unequivocally what their rights and obligations are before they commit themselves to any course of action.

29. The duties of Ofcom, amongst other duties, to act transparently, consistently, in a proportionate manner and to follow best regulatory practice, are contained in s.3(3) of the Communications Act 2003 ("the 2003 Act"). Although most of these duties are also duties imposed as principles of UK constitutional law, they derive as well from the Common Regulatory Framework ("the CRF"), and in particular from the Framework Directive 2002/21 ("FD"). Article 3(3) FD refers to the duty of Member States to ensure that National Regulatory Authorities ("NRAs") act transparently. Article 8(1) FD refers to the duty of Member States to ensure,

*"... that in carrying out the regulatory tasks specified in this Directive and the Specific Directives, the [NRAs] take all reasonable measures which are aimed at achieving the objectives set out in paragraphs 2, 3 and 4. Such measures shall be proportionate to those objectives."*

30. It follows from Article 8(1) FD that NRAs (including Ofcom) are obliged to act in accordance with the general principles of EU law as regards transparency, consistency and proportionality.

31. Although s.3 of the 2003 Act makes no reference to the principle of legal certainty, Ofcom is nevertheless also under a duty to have regard to that principle. The principle is a constitutional principle in the UK, forming part of the rule of law: *"the acceptance of the*

*rule of law as a constitutional principle requires that a citizen, before committing himself to any course of action, should be able to know in advance what are the legal consequences that will flow from it.*<sup>36</sup> It is also a general principle of EU law: “... the principle of legal certainty requires that Community rules enable those concerned to know precisely the extent of the obligations which are imposed on them. Individuals must be able to ascertain unequivocally what their rights and obligations are and take steps accordingly...”<sup>37</sup>

32. Those constitutional and general principles include the following requirements:
  - 32.1. to ensure that obligations are transparent, or, in other words that they are clear and foreseeable, and are known in advance so as to respect the principle of non-retroactivity<sup>38</sup>;
  - 32.2. as a matter of EU law, to observe the rules of legal certainty all the more strictly in the case of obligations liable to have financial consequences<sup>39</sup>; and
  - 32.3. similarly, to follow the rules of legal certainty strictly in cases where penalties or criminal liability may follow<sup>40</sup>. A penalty, even of a non-criminal nature, cannot be imposed unless it rests on a clear and unambiguous legal basis<sup>41</sup>.
33. Regulators frequently adopt guidelines which indicate how they will exercise their power in the interests of transparency and ensuring consistency and equality of application<sup>42</sup>. Guidelines often therefore explain and influence the extent of obligations imposed on those who are subject to regulation. It is therefore necessary for the guidelines to set out clearly and predictably the manner in which an obligation will be interpreted and enforced<sup>43</sup>.
34. As regards any policy that has been adopted:
  - 34.1. where practices or policies are adopted by a regulator, even though they do not form a part of the relevant legal rules, they nevertheless form rules of practice

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<sup>36</sup> Lord Diplock in *Black Clawson Ltd v Papierwerke Waldhof-Aschaffenburg AG* [1975] AC 591 683

<sup>37</sup> Case C-345/06 *Heinrich* [2009] ECR I-1659 at §44

<sup>38</sup> E.g. Case C-158/06 *ROM-projecten* [2007] ECR I-5103 §25

<sup>39</sup> *Ibid.* §26

<sup>40</sup> Case C-168/95 *Arcaro* [1996] ECR I-4705 §42; *Norris v Government of the United States of America* [2008] UKHL 16 at §53-54.

<sup>41</sup> Case C-248/04 *Koninklijke Coöperatie Cosun* [2006] ECR I-10211 §80

<sup>42</sup> For example, the European Commission's notice on the determination of the rules for the assessment of unlawful state aid [2002] OJ C119/22, were issued in the spirit of transparency and legal certainty

<sup>43</sup> C-386/10 P *Chalkor* (judgment of 8 December 2011) at §§ 59-60 concerning the Commission's guidelines on competition law fines. See also Case C-189/02 *Dansk Rørindustri* [2005] ECR I-5425, e.g. at §§211, 213, 221-3

from which the regulator cannot depart in an individual case without giving reasons which are compatible with the principle of equal treatment<sup>44</sup>; and

- 34.2. it would be inimical to good public administration for a public authority to have and operate a policy without making it public<sup>45</sup>.

### 3.3.3 The Relevance of the Tribunal's Judgment in the PPC Case [2011] CAT 5

35. BT fully understands that, in its approach to the Ethernet dispute, Ofcom would always be likely to follow the decision of the Tribunal in the PPC Case. As Ofcom well knows, BT challenges that Tribunal's decision and the request for permission to appeal along with the appeal itself is listed before the Court of Appeal in June 2012. Obviously therefore BT challenges the Tribunal's decision for the purposes of the present DD. To that end BT sets out its contentions in the final section of this Response.

36. However BT also contends that the DD goes far beyond what the Tribunal actually decided in the PPC Judgment and indeed is, in a numbers of respects, inconsistent with Ofcom's own approach in the PPC Final Determination. Accordingly BT will highlight what BT considers will be errors in Ofcom's approach in the DD based on an erroneous approach to the previous PPC dispute in order that Ofcom may evade committing avoidable errors in the Final Determination of this Dispute.

37. As Ofcom is well aware, appeals to the Tribunal are heard not only "*on the merits*" but "*by reference to the grounds of appeal set out in the Notice of Appeal*"<sup>46</sup>. It would be wrong therefore to assume that the Tribunal in the PPC Appeal was wholeheartedly endorsing Ofcom's approach in the original PPC Determination: the Tribunal was only properly considering the challenges contained in BT's Notice of Appeal.

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<sup>44</sup> Case C-189/02 *Dansk Rørindustri* [2005] ECR I-5425, e.g. at §§209 and 213. §213 explains that having regard to their legal effects and their general application the rules of conduct contained in the Commission's Guidelines on fines in competition law cases come, in principle, within the principle of "law" for the purposes of Article 7(1) ECHR. See also *Attorney-General of Hong Kong v Ng Yeun Shiu* [1983] 2 AC 629 at p638E-F

<sup>45</sup> *R (Walsley) v Lane* [2005] EWCA Civ 1540 at [57]

<sup>46</sup> As one example, Ofcom had carried out a series of adjustments to BT's data in order to recalculate the DSACs. As the Tribunal noted in §118 of the Judgment "*This formed no ground of appeal on BT's part*". The question of adjustments was therefore never a specific issue in the case before the Tribunal and therefore gave no guidance on the subject. What BT contends is clear is that if Ofcom decides to try and obtain the best figures from the data and make any adjustments, then it must be consistent and take all adjustments that are mooted into account: see further §4.

38. Excluding the issue over Ofcom’s jurisdiction and discretion in its use of the Dispute Resolution powers, BT’s challenges to the PPC Final Determination were limited to the following<sup>47</sup>:
- 38.1. That Ofcom had failed to take proper account of economic harm considerations in respect of which no evidence of economic harm had been adduced;
  - 38.2. Ofcom’s consideration of trunk and terminating segment services on a disaggregated basis was flawed and improper;
  - 38.3. Ofcom had erred in its approach to cost orientation by relying on an unlawful and inappropriate rule for cost recovery and cost orientation (the DSAC test);
  - 38.4. Ofcom had misapplied its discretion under Section 190(2)(d) of the 2003 Act.
39. It was these grounds of appeal upon which the Tribunal reached its conclusion. This is clearly reflected in the Judgment. For example:-
- 39.1. *“BT is not permitted to raise prices beyond those that are cost orientated, because this would be likely to cause economic harm: this was established by the anterior finding of the SMP made at the time the condition was imposed. Economic harm and breach of the cost orientation obligation are, therefore, two sides of the same coin.”* (original emphasis).<sup>48</sup>
  - 39.2. *“... we conclude that Condition H3.1 – on its true construction – applies to trunk services alone.”<sup>49</sup>* (emphasis added) Accordingly *“BT was in this case, faced with a fundamental difficulty, in that clearly it had orientated its prices by reference to aggregated PPC costs ... Once BT had lost this first point of construction, its ability to justify its cost orientation approach became extremely hard.”<sup>50</sup>*
  - 39.3. BT’s contention that DSAC were unlawful or inappropriate was rejected and the Tribunal made clear *“Treating DSAC as a ‘rebuttable presumption’ in relation to the appropriateness of a common cost allocation is a better description of the role that DSAC plays, but even this does not fully articulate the true effect of Condition H3.1. Treating DSAC as a rebuttable presumption also suggests that – if that presumption*

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<sup>47</sup> See for example §43 of BT’s Amended Notice of Appeal in the PPC case.

<sup>48</sup> See PPC Judgment § 326

<sup>49</sup> See PPC Judgment §226

<sup>50</sup> See PPC Judgment §§ 251 and 252



*is rebutted – there can be an investigation into the orientation of BT’s prices that carries on without reference to DSAC itself.”<sup>51</sup>*

39.4. In the circumstances of the PPC case Ofcom had exercised its discretion properly.<sup>52</sup>

40. What however the Tribunal was not specifically addressing (and therefore was not giving express guidance upon) was, for example:-

40.1. How to approach cost orientation of services in a single market with different characteristics to those of the PPC trunk service.

40.2. Thus the Tribunal only considered individual band widths for the trunk service (as opposed to a trunk and TISBO combined service) and did not specifically consider cost orientation in the context of a product involving a series of components at the same bandwidth and in the same market without which that product could not be supplied to the purchaser.

40.3. The Tribunal was also not considering what exactly is an appropriate return in the circumstances of a single market and particularly one that was relatively nascent.

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<sup>51</sup> See PPC Judgment §295

<sup>52</sup> See PPC Judgment §338

### 3. Background and Historical Context

#### 3.1 Introduction

42. In this section BT deals with two issues that are highly relevant to the approach Ofcom should take in its final determination and which BT considers Ofcom has not properly taken into account in the Draft Determination.

43. First, different markets have different characteristics. So that there is an inherent danger in seeking to rigidly apply an approach considered appropriate in the specific context of one market and to another quite different market. BT has already set out what was actually decided in the PPC Judgment. In this section BT therefore explores the very different factors involved in the Ethernet market, factors such as the:

43.1. nascent nature of the market;

43.2. significant and unanticipated explosion in demand that occurred;

43.3. absence of a settled track record of cost-volume relationships and likely volumes and costs upon which pricing decisions could be based; and

43.4. other regulatory pressures placed upon BT, for example the need to focus on certain products which Ofcom wanted to see launched and the dangers of discouraging migration to other products or over encouraging such movement (with the attendant risks on exponentially increasing volumes), which inevitably had an impact upon BT's pricing decisions.

44. Secondly, BT was given little (or no) guidance as to how it should approach cost orientation in the Ethernet market. Where guidance has been given by Ofcom (or previously Oftel), Ofcom in the Draft Determinations has radically (and unfairly) departed from that approach, including not carrying out an effects assessment. BT has already set out the legal requirements of transparency, consistency, proportionality and legal certainty in Section 2 above. BT will now expand upon these points in this section.

45. BT addresses these two points by providing a brief overview of:

45.1. the regulatory constraints BT was under and the guidance that was contemporaneously available to BT;

- 45.2. the history and context of the Ethernet market; and
- 45.3. Ofcom's past failure to make BT aware of the approach that it now proposes to take in the Draft Determinations.

## 3.2 A brief overview of the regulatory constraints

### 3.2.1 Ofcom's analysis

- 46. Ofcom briefly refers to the history of BT's cost orientation obligations / basis of charges type conditions in section 4 of the Draft Determinations. However this does not reflect the way that Ofcom's approach to cost orientation has developed over time. Nor does it reflect the other regulatory issues that were pertinent at the time. BT does not intend to rehearse all the regulatory background to this matter (of which Ofcom should itself be fully aware), but instead intends to give a contextual overview.
- 47. However this should not be taken as an acceptance as to the accuracy of section 4. BT will give just one example of its many inaccuracies. The Draft Determinations §4.9 omits the most important point in §6.28 of the May 1997 document: the quotation leaves a series of dots. These missing words are underlined in the quote here:

*"The relevant economic market must be identified and the nature of competition in that market analysed. The key question is the effect of the charge: floors and ceilings are useful yardsticks, since charges below the floor might typically be expected to be anti-competitive and charges above the ceiling usually excessive but circumstances may exist in which a charge .... above the ceiling may be justified."*

The omitted words were crucial to BT's understanding at the time.<sup>53</sup>

- 48. Indeed it was in this context that BT devised its Long Run Incremental Cost Methodology<sup>54</sup>. For Ofcom now to use the floors and ceilings in a way which departs from this, is inconsistent with the LRIC methodology and explains why BT is so concerned about Ofcom

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<sup>53</sup> In addition, E1DD §4.9 refers to the Consultation in May 1997, but incorrectly refers to floors and ceilings as a "first order test". The actual words used in both the December 1996 and May 1997 documents are "first test", not "first order test".

<sup>54</sup> Hence BT commented at §2.9 of its 6 May 1997 document on Long Run Cost Methodology (emphasis added): "Ofcom has proposed that a system of LRIC price floors and SAC price ceilings be introduced. The purpose of this is to determine the range of prices that BT can set for its Network components without BT acting anti-competitively. However Ofcom has recognised that it may be possible to set a price outside of the applicable ceiling and floor which is not anti-competitive. This may, in part be because the price floor proposed by Ofcom is, in fact, higher than the true LRIC of the service." [emphasis added]

refusing to allow BT to correct errors in the LRIC calculations: Ofcom is wrongly ignoring the limitations of the methodology.

### 3.2.2 A brief of overview of the guidance given as to cost orientation

49. As noted in §4.12 of the Draft Determinations, the concept of cost orientation was introduced by the Interconnection Directive in 1997<sup>55</sup> (implemented into UK Law by the Interconnection Regulations 1997). Although this and certain other EU directives were superseded by the CRF, it was not contemplated that the underlying intentions as to cost orientation or the other remedies contemplated by the Interconnection Directive were to be completely swept aside: see for example, Recital 14 of the Access Directive<sup>56</sup>. The intention was not, therefore, that the nature of the obligations should radically change, but simply that the need to impose them should be carefully considered in order to ensure that there was no “over-regulation”. The interpretation and application of condition HH3.1 cannot therefore be viewed as a radical departure from the cost orientation obligations that were then in place. Any previous guidance as to cost orientation (unless specifically changed) that has been given by the regulator in the context of the Interconnection Directive remained equally as valid in the context of cost orientation under the CRF.

50. This particularly includes Oftel’s 1997 and Ofcom’s 2001 NCC Guidelines (the “1997 Guidelines” and the “2001 Guidelines” respectively, together the “1997 and 2001 Guidelines”). It is important to stress that these were certainly not designed with the Ethernet market in mind. However, insofar as Ofcom has to date not provided any specific guidance as to how condition HH3.1 would apply, but did provide some guidance in the 1997 and 2001 Guidelines, the earlier guidance must be applied. Although at §§4.15 and 4.16 of the E1DD, Ofcom refers to the 1997 Guidelines, it fails to set out crucially important parts of the 1997 Guidelines. In particular the 1997 Guidelines gave the following clear guidance:

50.1. *“The primary focus of investigation of a complaint under Condition.... 13.4 [BT’s cost orientation condition] will however be the effect or likely effect of the charge on competition and on consumers” §3.5 (words omitted by Ofcom in its quotation*

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<sup>55</sup> 97/33/EC.

<sup>56</sup> *“Directive 97/33/EC laid down a range of obligations to be imposed on undertakings with significant market power, namely transparency, non-discrimination, accounting separation, access and price control including cost orientation. The range of possible obligations should be maintained but, in addition, they should be established as a set of maximum obligations that can be applied to undertakings, in order to avoid over-regulation.....”* [emphasis added]

in §4.15 of the Draft Determination). Thus these floors and ceilings were not a determinative test and only “might” indicate the possibility of an abuse: see §C.2<sup>57</sup>.

50.2. Although the “floors” and “ceilings” initially looked at “component costs”, when they were used as a test for abusive charging they had to be applied to the service as a whole “*because interconnecting operators purchase services not components*”.

50.3. Moreover, the 1997 Guidelines recognised the limitations of relying solely upon individual component costs. DSAC’s use was only considered as a pragmatic approximation for standalone costs. For example, the inherent problems in the incremental cost methodology for components were recognised at paragraph C18 of the 1997 Guidelines, where it was noted: “*degree of further complexity beyond the scope of the incremental costs methodology developed so far because the incremental cost of services would depend not on the total incremental costs of the components, but on the shape of the cost function for each component...*”.

50.4. It was precisely because Oftel was using the “distributed” floors and ceilings as a pragmatic alternative for a combinatorial test that Oftel needed to focus on the floors and ceilings at a more aggregated level. Oftel specifically accepted that looking at the floors and ceilings for individual components was not to be used as the test for abusive charging: §C.5.<sup>58</sup>

51. The material available prior to condition HH3 certainly did not make clear:

51.1. how exactly the floors and ceilings would be applied, and certainly did not suggest that they would be applied inflexibly, without taking account of other relevant market features;

51.2. the level of disaggregation at which the obligation would apply, and certainly not that it would apply rigidly at the level of the entries on a price list e.g. connections and rentals separately; and

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<sup>57</sup> “In investigating complaints about charges, Oftel would not apply the floors and ceilings test mechanistically. Floors and ceilings are an effective first order test for the likelihood of anti-competitive or exploitative charging. However there may be circumstances in which charges set outside the bands of floors and ceilings are not abusive, or charges set within the band are abusive. If asked to investigate charges, Oftel will seek to analyse the effect of the charge in the relevant market and will take a view on this based on the individual circumstances of each case.” [emphasis added]

<sup>58</sup> “The methodology derives floors and ceilings initially in terms of component costs but, to be used as a test for abusive charging, they will be applied to interconnection services (because interconnecting operators purchase services not components).” [emphasis added]

- 51.3. when BT would be deemed to have “failed” to comply with the obligation, and certainly not that this would be on the basis of a single year of assessment.
52. Condition HH3 was imposed in the course of the 2004 Leased Line Market Review (“the 2004 LLMR”) and set out in the June 2004 LLMR Statement. However the 2004 LLMR Statement:
- 52.1. did not give any guidance as to how compliance with Condition HH3.1 was actually to be tested;
- 52.2. made no reference at all to DSAC. If DSAC were the clear and obvious test for compliance with Condition HH3.1, one would have expected it to have been referred to;
- 52.3. noted that Ethernet was a nascent market; and
- 52.4. indicated, in the wording of Condition HH3.1 itself, that there was intended to be a degree of flexibility as regards BT’s permitted charges (for example the reference to what is “reasonable” and “appropriate”). The 2004 LLMR Statement places no limitation upon and indeed does not identify any parameters as to what “reasonable” and “appropriate” should mean in any given context. It is plain that what may be “reasonable” and “appropriate” is a question that must be assessed in the relevant context and will vary according to the market in question. Accordingly, policies which can be applied in relation to one market may simply not be relevant or suitable in relation to others.
53. BT’s compliance with Condition HH3.1 has therefore to be viewed entirely in the above context. Ofcom had a duty to make clear its policy as regards the parameters of cost orientation and what compliance with Condition HH3.1 meant. Insofar as Ofcom seeks to hold BT liable retrospectively for breaches of Condition HH3.1, Ofcom has contravened those obligations. BT develops this in section 3.4 below.

### **3.2.3 The EOI obligations**

54. A further factor is highly relevant in the context of condition HH3 and the Ethernet market. BT negotiated specific undertakings with Ofcom in September 2005 (the “Undertakings”) to avoid a market reference to the Competition Commission. Pursuant to these Undertakings

Openreach was created as a functionally separate line of business within BT and BT was required to create Equivalence of Inputs (“EOI”) for Backhaul Extension services and to *“launch a Wholesale Extension Backhaul Product which shall be offered on an Equivalence of Inputs basis”*<sup>59</sup> by 30 September 2006.

55. Obviously BT does not suggest that the EOI obligations excused BT from seeking to comply with condition HH3.1. BT does, however, make two points.

55.1. The establishment of Openreach brought about a major change of personnel and business structures. “Chinese walls” were put in place preventing open discussion between parts of BT Wholesale, BT Retail and Openreach. Moreover, the resources that needed to be used to ensure the EOI obligations were met, placed further constraints on BT. BT’s ability correctly to judge volumes and cost allocations, particularly in the Ethernet market, must therefore be gauged in that context.

55.2. Ofcom had a very clear agenda as to the type of products it wanted to see BT introduce. In particular Ofcom wanted to encourage other CPs to build alternative networks as far out as possible<sup>60</sup>. Ofcom therefore carefully scrutinised Openreach’s pricing and indeed wanted BT to price products to achieve this purpose, placing additional constraints on how BT could price its products

56. Both these points are explored further in section 3.3 below.

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<sup>59</sup> See paragraphs 8 and 9 of Annex 1 to the Undertakings.

<sup>60</sup> Accepting that there were enduring “bottlenecks” formed, in some parts of the UK, by BT’s “Access Network” as defined in §2.1 of the Undertakings

### 3.3 The history and context of the Ethernet market

#### 3.3.1 The nascent nature of the market

57. The beginnings of the wholesale Ethernet portfolio lie in the 2003 requests by Energis for wholesale Short Haul Data Services (“SHDS”) and other services<sup>61</sup>. While BT’s retail business had provided some SHDS and other services, these were limited in nature and BT had not been required specifically to report on these in any RFS.
58. The suggestion that Ofcom makes in the Draft Determinations<sup>62</sup> that BT should have had in 2004 a better understanding of cost, does not have sufficient regard to the organisation changes in 2005-06 and 2006-07, to the limited market for these products previously and to the new wholesale supply envisaged. BT had only a very limited idea of both what type of products the market might ultimately want and also what the take up for these products might be (discussed further below).
59. It is incorrect for Ofcom to suggest that the fact the (wholesale) products in question existed for a number of years prior to the Relevant Period<sup>63</sup> as “retail” services was sufficient to enable BT to accurately forecast volumes/costs. In so doing, Ofcom fails to attribute sufficient weight to the very real forecasting difficulties experienced by BT. Ofcom itself notes that “...BT is likely to have a better understanding than the regulator of demand across the markets in which it operates...”<sup>64</sup>. With this in mind, it is unclear as to why Ofcom considers it appropriate simply to disregard BT’s assessments of the likely market demand at the relevant time.
60. The assertion that in 2004 the Ethernet products market was nascent is one that Ofcom has itself repeatedly accepted: “The 2003/4 Market Review concluded that AISBO services were a nascent market and that imposing a charge control at that time was inappropriate and could impede market development...”<sup>65</sup> (emphasis added). In the period from 2004 until at least the end of 2006, Ethernet products (in the way the market is understood today) were only beginning to emerge.

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<sup>61</sup> These requests later became a formal dispute referred to Ofcom on 3 July 2003, which rejected some of the requested services but in its Final Determination of 3 September 2004 held that certain services falling within the AISBO market should be provided by BT (namely wholesale variants of existing retail SHDS known as LES). Ofcom’s subsequent 2004 LLMR Statement set out further requirements for the launch of these services (including the cost orientation obligation under Condition HH3.1).

<sup>62</sup> E1DD §8.53.1

<sup>63</sup> The Relevant Period is the period of dispute identified by Ofcom in each of the E1DD, the E2PD, and the E3PC

<sup>64</sup> E1DD §9.56

<sup>65</sup> §5.46 of the Leased Lines Charge Control Consultation, 8 December 2008



61. There was therefore simply no adequate historic track record on which BT could base a clear assessment of the cost orientation obligation imposed upon it by Ofcom in the 2004 LLMR<sup>66</sup>. The original wholesale variant launch pricing was subsequently reviewed, and was revised in early 2005 following industry consultation between BT Wholesale<sup>67</sup>, CPs and Ofcom. The key factor in pricing during the period 2004-05 to 2005-06 was the significant upfront capital investment required by BT Wholesale and then Openreach – once a circuit had been built from scratch for a customer it was unlikely to ever be used by another customer (i.e. it was very difficult to reuse the investment and local ends, in particular, were very much a sunk cost). In the resulting revised pricing, BT was trying to achieve prices that were acceptable to CPs and that allowed a reasonable return over the portfolio viewed as a whole.
62. It is easy now to criticise BT for failing to rigorously analyse the DSACs for individual products. BT sets out the lack of guidance Ofcom offered to BT as to how Ofcom expected BT to approach the cost orientation condition in section 3.4 below. Moreover, the reality was that BT at the time had to deal with difficult issues concerning what products exactly would be taken up by CPs, and in what numbers, and thus what costs would be incurred and how exactly costs might end up being allocated. There were other constraints such as the implementation of the Undertakings including the creation of Openreach and imposition of the EOI obligation (see further below). In the initial years BT was trying to judge cost orientation without adequate pre-existing cost and volume information. This made it very difficult to ascertain costs and cost allocations at a granular service level simply because of the very nature of the nascent market<sup>68</sup>.
63. These factors should not now be ignored by Ofcom. Ofcom (and the CAT in the PPC Judgment) recognised that prices for individual products above DSAC could still be cost orientated.<sup>69</sup> That is all the stronger in a nascent market.

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<sup>66</sup> Prices were initially set on a 'retail-minus' basis, using the GS retail LES product and cost stacks as a reference point. This however was a bit like taking a shot in the dark until some form of stable track record for the products, which the wholesale market actually decided it wanted, could be developed.

<sup>67</sup> BT Wholesale ("BTW") was, until January 2006, BT's business unit responsible for the provision of BT's wholesale data connectivity products; since January 2006 that responsibility has fallen on the then newly created Openreach business unit

<sup>68</sup> This is explicitly recognised by Ofcom at E1DD §8.25, "*Ofcom itself has acknowledged that the emerging nature of the AISBO market meant that an overly granular focus was an inappropriate tool for cost orientation*".

<sup>69</sup> See e.g. PPC Judgment §285

### 3.3.2 The difficulty of judging the anticipated take up volumes

64. These problems were not helped by the very real difficulties that the CPs themselves experienced in providing adequate forecasts in this developing market and specifically in giving proper information to BT as to the volumes that they anticipated would be required. In order to predict customer demand and plan its service provision appropriately, Openreach ran a formal forecasting process which included (i) requesting volume forecasts from its customers based on indicative prices; and (ii) internal analysis based on past sales as an indicator of future demand and an overlay of assumptions regarding the growth of the market. Such forecasts as were provided by the CPs were considered by BT to be patchy and unreliable.
65. Despite BT's best efforts with its forecasts, volumes significantly outstripped projected demand over the period, and certainly up to December 2008. BT will refer to one example of this from the summer of 2006. It is worth noting that, although by this stage Openreach was collating more data (and therefore forecasts might have been more accurate in the very immediate short term), there were still significant problems in anticipating longer term demand. Pricing Paper OPG 21/2006 was considering price changes to all WES products and therefore shows the projected volume figures for all the WES products.
66. The Pricing Paper OPG 21/2006 shows the following projected external volumes for rentals<sup>70</sup>. This can be compared with the figures in the model that Ofcom has relied upon in the Draft Determinations for actual volumes in the period (essentially the RFS figures with some adjustment<sup>71</sup>).

#### External Volumes [C]

	06-07 <sup>72</sup>	07-08	08-09	09-10
Actual	1,259	6,906	11,440	16,575
Projected	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

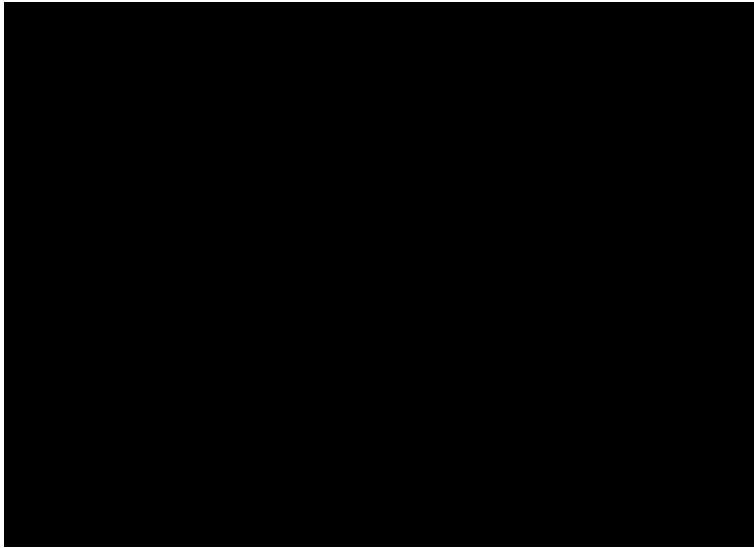
**Table 3.1**

This can be represented graphically as follows:

<sup>70</sup> In a separate cost stack summary by John Rowe – worksheet volumes and assumption. BT has illustrated this by rentals, given that in the E1DD the vast majority of the alleged years of overcharges by BT are centred on rental items

<sup>71</sup> See e.g. E1DD §12.42.2.

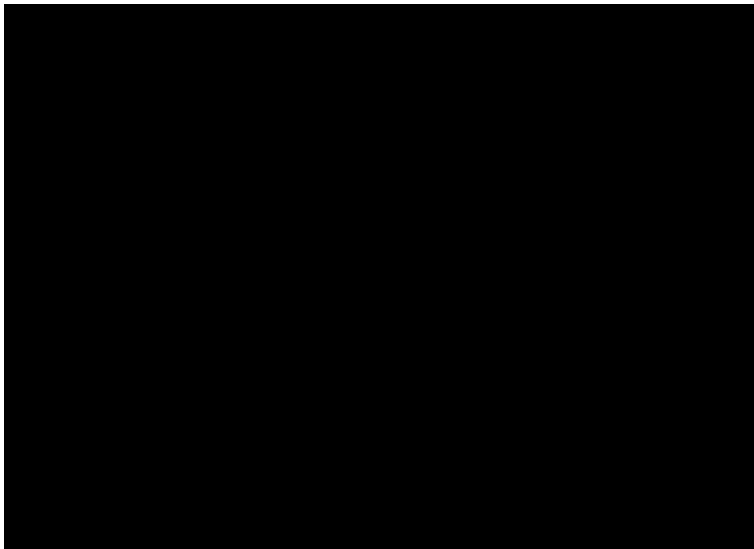
<sup>72</sup> BT obviously was more likely to get the projected figures for this year more in line with actual volumes since BT was already part through this year.



**Figure 3.1 [C]**

67. Graphs for individual WES external volumes for the rental component show a similar pattern for the products that were then in most demand (WES 10 and WES 100<sup>73</sup>).

**WES 10 External Volumes [C]**



**Figure 3.2**

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<sup>73</sup> Although WES 1000 shows for 2006-07 and 2007-08 a less dramatic picture, the initial demand for this product was much lower and relatively small volumes were involved. However once the product became established there was again an explosion of demand above what had been anticipated.

## WES 100 External Volumes [C]



**Figure 3.3**

68. Independent forecasters were suggesting<sup>74</sup> that there was going to be a much lower product take-up than the substantial take up that in fact occurred. In the event this huge and unanticipated take-up in demand led Openreach to face a so called “service crisis” as it found it difficult to keep up with the unexpectedly high volumes. As a result, Openreach had to pay out significant amounts in service level guarantees (“SLGs”).
69. It was not simply volumes that were changing substantially, but costs as were altering as well. For example at this time Openreach was also developing business to business interfaces to allow for online ordering and remote diagnostic capability making the network more efficient. The successful implementation of the customer interfaces enabled reduced overheads and costs in addition to continuously reducing electronics cost.

### **3.3.3 Ofcom’s involvement and the impact of the EOI obligations**

70. As already indicated above, in late 2005 and 2006 BT was subject to the EOI obligations. This led to many meetings and a close working relationship with Ofcom throughout 2006-2008 regarding the development of BT’s and Ofcom’s strategic approach to Ethernet product pricing. This included BT giving Ofcom significant amounts of cost information as to BT’s pricing. If Ofcom had concerns or felt that BT needed to do more to justify its pricing, then Ofcom, as a regulator, should have given BT guidance at that stage. BT sets out its concerns about Ofcom’s lack of guidance in section 3.4 below. Here BT will give one

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<sup>74</sup> See 20 May Response §39 20

example of the level of Ofcom's involvement and the pricing constraints that Ofcom itself was imposing on BT.

71. One area Ofcom was particularly interested in was the development of WESA, WESB and WEES product variants. Ofcom asked BT to provide cost information for the pricing approaches that BT had developed at that time. Ofcom was anxious to create a framework encouraging CP investment in alternative network build<sup>75</sup>. Ofcom wanted to see Openreach's prices at levels which gave an incentive to competing CPs to build backhaul connections whilst purchasing WES access circuits from Openreach and without suffering a pricing disadvantage compared with WEES prices, whether or not Openreach prices would reflect efficient costs (additional electronic boxes were needed for a WESA-WESB-WESA compared with a WEES). The detailed level of discussion in which Ofcom was involved within BT throughout this process can be seen for example from an early meeting on 29 March 2006<sup>76</sup>.
72. In this context, Openreach understood that Ofcom wanted a sufficient price-cost margin in the pricing of Openreach's Ethernet products for backhaul competition to be able to flourish on a price competition basis, rather than to achieve very narrowly construed cost orientated prices. There was a clear tension between Ofcom's unbundling and other regulatory policies, at least on the basis of the strict interpretation of the cost orientation obligation that Ofcom now proposes to apply.
73. In any event, the balancing of Ofcom's concerns and the effects on existing customers made this a complex exercise involving an analysis of current prices, customer requirements, balance of WEES and WESA/WESB, and future pricing strategy (i.e. Orchid). A flavour of the problems that BT faced can be seen from an e-mail from Karen Wray dated 28 August 2006 following on from a meeting with Ofcom which states:

[“  
[REDACTED]

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<sup>75</sup> Notes of meeting with Ofcom to discuss 20CN WES/BES EOI Solutions Design and related questions on 29 March 2006.

<sup>76</sup> Included in the additional document bundle attached to this response.

[REDACTED]”] [C]

74. Moreover, throughout the 2006-2008 period, Ofcom was well aware that BT was seeking to re-balance its prices, and that the considerations which BT took into account included the interests of existing customers who had already made purchases based on earlier prices. Equally, there was a considerable focus by Ofcom on seeing that BT made the services available to customers and allowed the development of LLU. It was not suggested at any stage that BT’s pricing was an impediment to that development. To illustrate the type of involvement Ofcom had in BT’s pricing, BT would point to an email from BT’s Kevin Woodnutt to Ofcom’s Gareth Davies, dated 20 October 2006, specifically dealing with “Ethernet Pricing Review”

[“ [REDACTED]”] [C]

75. This is further demonstrated by internal notes of an Ethernet Pricing Review meeting held between BT and Ofcom on 19 December 2006:

[“ [REDACTED]”] [C]

(See in the particular context of WES 10 rental in section 6.2.3)

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<sup>77</sup> “Ethernet Price Review Update for Ofcom – Internal Notes, 19 December 2006”

### 3.3.4 The difficulties of the initial period at least up to March 2007

76. BT was therefore taking its pricing decisions in the context of the nascent nature of the market, the absence of a settled track record of cost-volume relationships and likely volumes and costs upon which pricing decisions could be taken, a significant and unanticipated explosion in demand and other regulatory pressures placed upon BT. BT was always aiming to achieve cost orientation as its pricing papers show<sup>78</sup>.
77. However, Ofcom must note the caution expressed by the CAT in the PPC Judgment<sup>79</sup>, namely that it might be quite difficult for BT prospectively to meet its cost orientation obligation even it had the firmest intention of so doing not least because of the difficulties of cost allocation, the complexities of cost accounting involved and the fact that costs can “*fluctuate over time sometimes quickly*”. If that is true of a mature and stable market, such as Trunk, it is significantly more important and relevant in a market that has been recognised by Ofcom as “nascent”, particularly given the other factors involved.
78. Given the inherent problems BT faced in the early years (certainly when looking at period 2005-06 to 2006-07), it is wrong for Ofcom to rely on whether individual component charges were above DSAC to determine: (i) whether BT’s charges were cost orientated and compliant with Condition HH3.1; or (ii) how much BT should repay to the Disputing CPs.
79. Ofcom should accept the difficulties BT faced in 2005-2007 and should also therefore accept that because of them either BT was not in breach of its cost orientation obligation or it would be unfair or unreasonable for BT to repay any charges over DSAC for that period. For 1 April 2006 to 31 March 2007 Ofcom estimates that the repayments to the CPs total £35.7 million<sup>80</sup>.

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<sup>78</sup> To give one example, Pricing paper OPG 27/2006 (supplied to Ofcom on 15 November 2011 with BT’s s.191 response) introduced a new WES and WEES 1000 Extended Reach. The Paper noted [“

”] [C]

<sup>79</sup> PPC Judgment §299

<sup>80</sup> Table 13.15 of the E1DD and Table 7.2 of the E2PD. This effectively relates to the pricing decisions that BT took at the latest in the period December 2005 to December 2006 since there was a 90 day contractual period for BT to introduce new charges. That is less than 1.5-2.5 years after Condition HH3 had been imposed in this nascent market.

80. This is a significant sum for BT to have to pay in light of the difficulties BT faced and the problems that the CAT recognised with ex ante compliance. A decision that ignores this (as Ofcom proposes in the Draft Determinations) would not only be harsh and mechanistic, it would be grossly unfair to BT given the circumstances that it faced and the level of Ofcom's involvement.

### 3.3.5 Further issues in the period 2007 onwards

81. BT should make clear that it is not suggesting that Ofcom's involvement and BT's difficulties came abruptly to an end after March 2007. To the contrary Ofcom continued to meet with and be supplied with information by BT. For example, at this time, BT was exploring the development of a new generation of Ethernet services as part of Project Orchid.

82. The Ethernet Backhaul Direct ("EBD") products being developed at that time enable multiple services to be carried across a single fibre, unlike WES and BES which require a separate fibre per service, and were needed to mitigate the risk of exhaustion of fibre capacity by the rapid growth in demand for Ethernet services and resulting future duct and fibre provisioning costs for continued point to point (as opposed to shared) fibre used. Openreach regularly briefed Ofcom about the work in progress to help it understand the direction in which the Ethernet strategy was heading. The discussions focused on how Openreach would be more efficient in backhaul, which was a particular concern of Ofcom<sup>81</sup>.

83. The evolving technology and development of a new generation of products brought with it novel problems. There was some concern that Openreach might not have the capital to invest in Orchid if its prices were driven down too much as part of the Business Connectivity Market Review ("BCMR") process, and confusion around how the cost orientation obligation would apply in the face of massive expenditure on electronics for the system as a whole (in contrast with a previously very linear world where Openreach could articulate the cost of electronics).

84. Ofcom's deep interest and involvement in whether BT's prices were cost orientated can be seen from another email from Ofcom's Gareth Davies. On 3 July 2008 Mr Davies wrote to BT's Mark Shurmer in connection with BT's new Orchid products:

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<sup>81</sup> While in earlier years, Ofcom's focus on WESA and WESB had been about 'component' costs or disaggregation, Ofcom was now moving on from this towards a focus on the more efficient delivery of backhaul through the use of ring technology and WDM. This was perceived to match the needs of customers such as LLU operators.



[“ [REDACTED] ”] [C]

### 3.3.6 Ofcom’s specific consideration of cost orientation in 2007 and the BCMR

85. On 11 May 2007, Thus lodged a formal complaint with Ofcom concerning, inter alia, alleged breaches of BT’s cost orientation obligations in respect of the Ethernet market. As Ofcom’s 2004 Draft Dispute Guidelines recognised a “complaint” was a different regulatory route to raising a dispute. At the same time Ofcom was also requesting information from BT concerning the Business Connectivity Market Review<sup>82</sup>. A s.135 information demand was made to BT. That was equally permissible for the investigation of a cost orientation compliance complaint and a market review<sup>83</sup>.

86. BT supplied the information specifically on the following basis:

*“The title and some of the commentary included in the letter implies that the information is requested in order to inform a Market Review, however it is our understanding that the information requested and that we have supplied, is to be used in order to assess BT’s compliance with Ofcom’s SMP Condition HH3. It is for this purpose that the information is provided.”*

[emphasis added]

87. Ofcom suggests in §10.70 of the Draft Determinations:

*“we did not reply to BT accepting its purported revision of the purpose of the LLMR information request. Further, as this was a notice issued by Ofcom under section 135 of the Act, we do not consider that BT could legitimately expect that its statement could replace the purpose stated in the statutory notice.”*

88. However, if Ofcom was accepting the information for an entirely different basis to that on which it was proffered, it was incumbent on Ofcom to make it clear that it was not going to

<sup>82</sup> At that stage CPs tended to raise complaints rather than seek to use the Dispute Resolution process under s.185 et seq. of the 2003 Act: see for example NCCN 500.

<sup>83</sup> S.135(3)(a) of the 2003 Act specifically includes any information required for “*ascertaining whether a contravention of a condition [under Chapter 1 of Part 2 (including SMP conditions under s.87)] ... has occurred or is occurring*”

use the information for that purpose. As already made clear above, this is not a question of legitimate expectation, it is one of regulatory certainty and transparency.

89. Be that as it may, nothing in the s.135 demand or what happened thereafter gave BT any indication that Ofcom was not considering whether BT's charges were cost orientated. To the contrary all the material suggested that Ofcom was going to directly consider whether BT's charges were cost orientated. For example:

89.1. Ofcom specifically asked at question 6 in the s.135 demand "*Provide any information (other than that requested about)... that BT considers is relevant to demonstrating that BT has satisfied its ex-ante cost orientation obligation*".

89.2. The material that BT provided was, therefore, not simply confined to the specific products that Ofcom suggests Thus were complaining about. (In fact Thus also made general complaints concerning BT's alleged breach of its cost orientation conditions and the complaint was not so restricted as Ofcom suggests at §10.67 of the Draft Determinations<sup>84</sup>). The material that BT provided to Ofcom covered a whole range of material on the cost orientation of BT's prices in the Ethernet market.

89.3. Ofcom (by e-mail from Katherine Dinsdale dated 10 July 2007<sup>85</sup>) notified BT of the outcome of its investigation of the Thus Complaint. The email stated:

*"..... Ofcom has decided, on the basis of administrative priority, not to open an investigation into the THUS complaint about BT's Ethernet product portfolio... In reaching this decision, Ofcom has not considered the merits of THUS's allegation that BT's WES/WEES Ethernet product portfolio is .... not cost orientated..... Ofcom considers the merits of a complaint only once an investigation begins. .... In deciding whether to open an investigation, Ofcom considered the factors set out in its Draft Enforcement Guidelines, in particular, whether there are alternative proceedings within Ofcom that are likely to achieve the same ends..... Having considered the THUS complaint carefully we consider that the issues raised are likely to be dealt with in the LLMR... A decision not to open an investigation due to administrative priorities does not prevent Ofcom from investigating similar conduct in the*

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<sup>84</sup> For example at page 10 of its letter of 11 May 2007, Thus commented "We suspect that this rebalancing from connection charges to rental charges has been achieved in recovering cost elements through rental which were previously recovered through the connection charges..... BT will in effect be recovering these costs elements twice, first through the LES connection charge and second through the WES/WEES rental." Likewise the central allegation related to price rebalancing that would carry forward into at least June 2008 (see e.g. Table 2) and so was not confined to a particularly truncated time period.

<sup>85</sup> Email from Katherine Dinsdale to Karen Wray entitled "Re: Thus complaint – Ofcom decision to close", sent on 10 July 2007 (10:45)

*future, or re-considering the same conduct where significant new evidence arises”.*

[emphasis added]

- 89.4. BT was therefore fully entitled to conclude (and certainly Ofcom never made the contrary clear) that Ofcom would in the LLMR consider the issues of cost orientation because that was the alternative means by which it would deal with the complaint.
- 89.5. Ofcom refers to this e-mail at § 10.65 of the Draft Determinations but omits the key underlined section in 83.3 above. This undermines the suggestion at §10. 74 of the Draft Determinations that, *“Ofcom considers that it would only be in a position to reach a conclusion on whether or not BT’s charges were cost orientated after it had carried out a detailed investigation of BT’s costs. Ofcom did not carry out such detailed investigation and did not reach a conclusion on whether BT’s charges were cost orientated during its work in preparing the 2008 BCMR Statement and the subsequent 2009 LLCC, or at any other time.”* Certainly, whatever Ofcom may have thought internally at that stage, none of this was communicated to BT at the time.
90. This accordingly represents a further example of the total lack of clarity as to how Ofcom was approaching BT’s cost orientation compliance.

### **3.4 The failure to make BT aware of the approach that Ofcom is now proposing to take**

#### **3.4.1 Matters not made clear to BT**

91. In the present case, Ofcom never made clear to BT, at the time when BT was setting the prices which are the subject of the present disputes and was therefore still able to re-organise its prices (i.e. not just to reduce them, but to reduce some and raise others), that BT would be expected to do any of the following:
- 91.1. set its charges and be able to justify those charges to Ofcom in accordance with Condition HH3.1 for each individual product or service in its price lists from time to time<sup>86</sup>; and

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<sup>86</sup> Ofcom now considers that this is what BT was obliged to do: see e.g. E1DD §§8.6, 8.45, and §§12.9-12.14

- 91.2. set its prices and be able to justify those prices to Ofcom in accordance with Condition HH3.1 separately for particular items within each bandwidth;
92. The clearest example of this is the position vis-à-vis connections and rentals (as explained below and in Section 4) but the point regarding overlapping services is not just limited to connections and rentals.
93. Nor was it made clear to BT that Ofcom would:
- 93.1. apply a first order accounting test in such a way (that is, with only very limited flexibility) so that the relevant economic features of a particular market were not taken into account and thus give little or no weight to the relevant economic features of the Ethernet market, such as the following:
- 93.1.1. the substantial growth in purchases by CPs<sup>87</sup>;
- 93.1.2. the presence on the market of other CPs acting in competition with BT (for example Virgin Media);
- 93.1.3. significant investments in new technologies made by BT which enabled the roll out of new services like LLU; and
- 93.1.4. the need for price signals with regard to take up of newer (e.g. 21CN) technologies;
- 93.2. apply an approach to Condition HH3.1 which could be “failed” by BT where prices exceeded DSAC for only 1 year (as was the case, according to the E1DD, for BES 1000 connection in 2006-07, and WES 10 rental for 2008-09); Ofcom states in the E1DD that the obligation in Condition HH3.1 will be “failed” unless BT can show that the charges were nonetheless cost orientated<sup>88</sup>, and in the case of the latter BT could also show that it reasonably expected its prices for that year to fall below DSAC<sup>89</sup>; and
- 93.3. apply an approach to Condition HH3.1 which could be “failed” by BT where BT had reduced its prices specifically to attempt to satisfy that obligation but not quite far enough (as is the case, according to Ofcom, in relation to 2009-10 for BES 100

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<sup>87</sup> E1DD §13.23 and fn. 359

<sup>88</sup> E1DD §§13.54, 13.60

<sup>89</sup> E1DD §13.58. As explained elsewhere in this document Ofcom’s proposed approach is also contrary to the PPC Judgment.

rental<sup>90</sup>), unless BT can provide specific evidence to demonstrate that it reasonably expected the unit DSAC for that year to be high enough that the charges would not exceed DSAC<sup>91</sup>.

94. Ofcom now seeks to rely on each of these matters against BT. To do so would be unfair and unjustified. None of these matters was reasonably foreseeable by BT, and none was made clear to BT by Ofcom. In view of that fact, the setting out of Ofcom's policy in advance explaining Ofcom's approach in general terms was all the more necessary in the interests of transparency.
95. It does not detract from that duty, that some of the matters raised above are specific points which would not normally be included in regulatory guidance or policy statements. Ofcom could have explained in advance, for instance, that (as now appears to be its policy) departure from a first order accounting test such as DSAC would only be permissible in very limited circumstances whatever the nature of the market, or it could have explained the approach set out in §9.55 of the Draft Determinations regarding the approach in a price inelastic market. It could also have made clear that it intended that every entry in a price list be required to satisfy Condition HH3.1, notwithstanding the fact that that would require a disproportionate level of detail, or that services were bought together or overlapped, or that there may be legitimate reasons why prices within a particular market should be differentiated so as for example to send appropriate signals for example about the take up of new technology.
96. BT's complaints in this regard are of course all made on the assumption that Ofcom's final determinations follows the approach that is set out in the E1DD. Clearly if, for example, Ofcom were to take the matters referred to in the rest of this response above properly into account in its approach to BT's charges then the point may become otiose. However, the E1DD suggests that Ofcom's current approach is to apply DSAC with little or no flexibility specifically in the areas set out above.

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<sup>90</sup> E1DD §13.34

<sup>91</sup> See Sections 7 & 8 of this Response where BT explains why Ofcom's proposed approach is contrary to the PPC Judgment.

### 3.4.2 BT was not informed of these matters in advance

97. BT explains below why it says that it was not informed in advance of any of these matters so as to enable it to organise its affairs appropriately. It does so by reference to the following categories. Of course, the overall effect of the combination of these factors on BT's understanding also has to be evaluated and appreciated:

97.1. the wording of Condition HH3.1;

97.2. the 2004 LLMR Statement;

97.3. the 1997 and 2001 Guidelines;

97.4. BT's dealings with Ofcom during the period 2005-20008;

97.5. the 2009 LLCC and Ofcom's letter to BT of 6 December 2010; and

97.6. Annex 14 of the Review of Narrowband services wholesale markets.

98. These categories fall into two parts. Categories 83.1 to 83.3 explain why, in BT's view, Ofcom has not clearly set out its approach to the application of Condition HH3.1 that it proposes to rely on in relation to Ethernet. Categories 83.4, 83.5 and 83.66 illustrate the fact that it was not just BT that did not appreciate these matters. Ofcom itself does not appear to have had a clear understanding the parameters of Condition HH3.1 (at least in certain key respects), until it came to consider the disputes in relation to PPCs and Ethernet. If it did have such an understanding, it would have been in the interests of transparency and legal certainty to explain that understanding to BT and others in a policy document.

99. Thus, whilst BT relies on the breaches of specific legal rules identified below, BT also makes the more general point that it is unjust and disproportionate to require payments from BT because of a failure to comply with standards or policies which Ofcom had, until the Draft Determinations were published, not made transparent. In the Draft Determinations Ofcom indicates that it was not prepared to accede to the requests of the Disputing CPs to use FAC rather than DSAC as an appropriate first order test. It stated<sup>92</sup>:

*"If we were to now change the maximum pricing level to FAC we would be acting in a manner that is inconsistent with the position as understood by Ofcom, BT and the CPs that were paying the charges, at the time those charges were levied."*

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<sup>92</sup> E1DD §9.61

BT agrees with that position of principle, and contends that by the same logic BT should not be subject to orders for repayment as a result of matters that it did not know, and had not been made plain to it by Ofcom.

### 3.4.3 Condition HH3.1

100. Condition HH3.1 does not spell out any of Ofcom's policies in relation to any of the matters identified in the previous section. This point can be illustrated very simply by the fact that Condition HH3.1 does not even refer to DSAC, let alone explain how DSAC will be applied in particular circumstances. It certainly provides no relevant information about the other matters referred to above.<sup>93</sup>
101. Condition HH3.1 shows that there is intended to be a degree of flexibility as regards BT's permitted charges. The Condition makes reference to what is "reasonable" and "appropriate". It does not identify any parameters as to what "reasonable" and "appropriate" should mean in any given context. This is hardly surprising since, as Ofcom accepts<sup>94</sup>, Condition HH3.1 applies not just in the AISBO market, but also in the Traditional Interface Symmetric Broadband Origination ("TISBO") market. Ofcom appears to accept in principle, as seems entirely logical, that what may be "reasonable" and "appropriate" will vary according to the market in question, and that policies which can be applied in relation to one market may simply not be relevant or suitable in relation to others<sup>95</sup>.
102. Although BT accepts that the CAT in the PPC Judgment has made clear that BT cannot aggregate charges across markets and has made clear that, at least in the PPC market, BT should focus in part on products in individual bandwidths, the PPC Judgment simply did not deal with the detailed levels of disaggregation that Ofcom proposes in the present case. The CAT was simply not considering the circumstances of the Ethernet market. These findings in the PPC Judgment cannot therefore detract from the point being made, namely that the matters referred to above were not explained to BT.

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<sup>93</sup> Ofcom's own approach to DSAC as a first order test also seems to be somewhat contradictory. For example, while Ofcom suggests that DSAC is a first order test only, it suggests elsewhere in the E1DD (§9.49) that *"the DSAC test should play a central role in determining whether BT overcharged its external customers"* and (at para 12.110) that Ofcom places *"significant weight on whether BT's Ethernet charges were above their DSACs"* – this does not seem to sit comfortably with DSAC as a first order test only.

<sup>94</sup> E1DD §8.49.1

<sup>95</sup> e.g. E1DD §§8.52, 8.55, 9.78, 13.25, and the heading preceding E1DD §13.17 *"How do we take account of the specific circumstances of the AISBO market?"*

103. Indeed the very fact that Ofcom relies on the 1997 and 2001 Guidelines in numerous parts of the E1DD<sup>96</sup> reinforces the fact, if any reinforcement were needed, that Condition HH3.1 does not provide any detail whatsoever about how the cost orientation obligation contained in it is to be applied. These are discussed further below.

#### **3.4.4 The 2004 LLMR Statement**

104. Like Condition HH3.1, the 2004 LLMR Statement, of which it formed a part, did not explain how the cost orientation obligation was to be applied. Such indications as there were suggested that there would be latitude arising from the fact that Ofcom recognised that the AISBO market was a nascent market. BT has already referred to the relevant passages in this regard in its 20 May Response<sup>97</sup>. It does not set them out again here but reference should be made to §§7.58 and 7.59(iii) of the 2004 LLMR Statement.

#### **3.4.5 The 1997 and 2001 Guidelines**

105. The 1997 and 2001 Guidelines do not provide extensively more detail than Condition HH3.1 and the 2004 LLMR Statement as regards Ofcom's actual policies in relation to cost orientation. However, as explained in section 3.2.2 above, such detail as there was suggested that Ofcom would be prepared to examine the market in question and take a flexible approach. BT has, as Ofcom knows, complained in its Notice of Appeal to the Court of Appeal in the PPC case about the CAT's failure to apply the 1997 and 2001 Guidelines to the facts of the PPC case<sup>98</sup>.

106. Ofcom seems to be in no doubt that the 1997 and 2001 Guidelines were relevant. However, it has failed to apply the 1997 and 2001 Guidelines in the present case. In particular it has failed to assess the relevant market and to take those factors into account.

107. The circumstances in the present case were very different from those in the PPC case. The Ethernet market is a single market (and there is no question of BT seeking to aggregate charges across two separate markets). As already explained in section 3.3 above, the market was a nascent one, certainly in the period 2004-06 to 2006-07, at least. BT had

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<sup>96</sup> e.g. E1DD §§4.15, 4.16, 4.34, 5.3, 9.59, 11.31-33, 11.62

<sup>97</sup> 20 May Response §30(ii)

<sup>98</sup> BT's Skeleton Argument §§121-132



limited information on historic costs and on the demand for the likely take up of products (and actual demand completely outstripped the projected estimates). BT was also subject to other pricing constraints and liaised fully with Ofcom at the time.

108. However, on any view and regardless of whether Ofcom's approach has been consistent with the 1997 and 2001 Guidelines, the 1997 and 2001 Guidelines do not contain sufficient detail so as to make clear Ofcom's intention to apply the policies identified above in appropriate cases. Nor do they give reasonable grounds for believing that any similar policies would be applied by Ofcom. In those circumstances it would be wrong for Ofcom now to rely on those policies.
109. The 1997 and 2001 Guidelines were uncertain as regards all of the matters set out above, because they did not specify the level of service or product at which the obligation applied, did not say how the DSAC test would be applied, or when it would be regarded as "failed", or give an indication of the "second order" approach to be used., or of any of the detail of the cost allocation methods that would be appropriate.

#### **3.4.6 BT's dealings with Ofcom during the period 2005-08**

110. As Ofcom is well aware, and as BT has explained both in its 20 May Response<sup>99</sup> and in section 3.3 above, BT had close contacts with Ofcom over BT's pricing and portfolios, particularly throughout the period 2005-06 to 2007-08. Throughout this period, Ofcom was well aware that BT was seeking to re-balance its prices and that the considerations which BT took into account included the interests of existing customers who had already made purchases based on earlier prices. Equally, there was a considerable focus by Ofcom on seeing that BT made the services available to customers and allowed the development of LLU. It was not suggested at any stage that BT's pricing was an impediment to that development.
111. As a result of these frequent contacts, Ofcom had very many opportunities to explain to BT what was required of it as regards compliance with Condition HH3.1 in the Ethernet market. The fact that it did not do so, suggests that Ofcom had not then formulated any policy or approach such as that it now proposes to apply.

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<sup>99</sup> 20 May Response §§43-46

112. This is not simply a case where a regulator has not checked whether compliance was being secured, and its silence or failure to point out difficulties is not to be taken as assent, or to found any sort of legitimate expectation. So far as BT is concerned, the approach to the application of Condition HH3.1, as now proposed, was not made clear to it, and had not been developed or appreciated by Ofcom itself. For example, it came as a considerable surprise to BT that Ofcom contemplated requiring every one of the 202 WES and BES entries and 171 EAD and EBD entries on the Openreach price list (“OPL”) to satisfy the DSAC test. Further, the idea that rentals and connections were also to be subjected separately to the DSAC test for each service was something that was never obvious or clear to BT.
113. The lack of clarity or guidance from Ofcom as to the meaning of cost orientation during the Relevant Period indicates that the application of a strict test based on DSAC ceilings for each individual component service or price list entry is disproportionate and breaches Ofcom’s duties of proportionality and transparency, in particular when applied retrospectively.<sup>100</sup>

#### **3.4.7 The 2009 LLCC and the 6 December 2010 Letter**

114. A specific example of the fact that Ofcom’s mind has altered in the present case is the position of connections and rentals. Ofcom’s “first thoughts” as contained in the 2009 LLCC at §5.8, and in the 6 December Letter were that it would be appropriate to consider compliance with Condition HH3.1 in relation to connections and rentals together.
115. Ofcom’s latest approach which treats connections and rentals separately is simply wrong (as explained in Section 5 below). It also breaches Ofcom’s duty as set out above to act consistently with its previously stated position. Ofcom has not given any reasons why the analysis of the market in relation to connections and rentals has changed from the description given in the 2009 LLCC. The reasons it does give do not affect the factual position in the market.
116. However, even leaving these points aside, if Ofcom who looked specifically at the market in preparing the LLCC in 2009, and subsequently wrote the letter of 6 December in 2010, considered at those times that it was justified in looking at the position of connections and

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<sup>100</sup> Indeed Ofcom ignored BT’s reliance on DSAC ceilings in the “Dispute Relating To Sub-Loop Unbundling Charges Determination” of 15 July 2011.

rentals together, it would be disproportionate and unfair to say that BT was clearly under an obligation throughout the relevant period from 2006-07 onwards to ensure that Condition HH3.1 was satisfied in relation to connections and rentals separately, and that it should be required to make repayments to CPs specifically on that basis. Whether or not it would be disproportionate for Ofcom to impose such separate requirements on a forward looking basis following the BCMR and 2009 LLCC, it is disproportionate for Ofcom to do so retrospectively without previous notice or clarification of the position to BT and is a breach of Ofcom's duties of transparency and proportionality under the 2003 Act.

117. In both of these documents, Ofcom made clear that it was not determining the cost orientation position specifically. Nevertheless BT submits that it is contrary to the principle of legal certainty that Ofcom should be permitted to develop and rely on a policy in relation to connections and rentals some years after the period in which BT set its prices, and when it is too late now for BT to adjust its prices, in circumstances where Ofcom's own reactions were the same as BT's in 2009 and 2010.

#### **3.4.8 Annex 14 of the Review of Narrowband services wholesale markets**

118. On 15 September 2009, Ofcom published its statement on its Review of Narrowband services wholesale markets. It published an Annex 14 to that document which "*provides guidance in interpretation of the basis of charges obligations which we have imposed on BT and KCOM in several markets in Sections 11 and 12 of this statement*"<sup>101</sup>. The basis of charges obligation in those markets referred to in Sections 11 and 12, was identical in its wording to condition HH3.
119. The very fact that Ofcom felt it had to issue such "guidance" demonstrates (a) the limited clarity that the actual wording of the cost orientation condition could provide and (b) that there was in effect incomplete guidance contained in the earlier material (such as the 1997 and 2001 Guidelines). It should also be noted that in Annex 14 Ofcom especially noted that with nascent products (of which, as explained in section 3.3 above, there were many in the Ethernet market, itself in 2004 a new regulatory market) one must recognize "*the importance of incentives to innovate and invest and because their characteristics and costs are not yet known (and the product life cycle issues make simple cost comparisons very*

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<sup>101</sup> §A14.1 of Annex 14 to that consultation document

*difficult).*<sup>102</sup> These are all points that BT made in its 20 May Response and which are reiterated in this document.

120. The contents of Annex 14 had not been included in the Narrowband Services Wholesale Market consultation of 19 March 2009, or anywhere else. BT therefore complained about the lack of consultation on this new “guidance”, which breached the transparency and consultation requirements of the 2003 Act. Ofcom did not object to BT’s (and other CPs’) complaints on the basis that the guidance (and underlying policy) was already clear. To the contrary Ofcom withdrew Annex 14 specifically because it considered it had first to consult upon it, i.e. the underlying policy was not clear. A better example of the uncertainty inherent in the cost orientation obligation could not be given.
121. Below we further expand on the need for Ofcom to take better account of the duration of any period over which the DSAC first order test was failed (Section 7) and of the implications of Ethernet being a nascent market (Section 8).

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<sup>102</sup> §A14.6 of Annex 14 to that consultation document

## 4 Cost Adjustments and Proxies

### 4.1 Introduction

122. For the purposes of these Disputes, this section explains the adjustments needed to the published RFS figures to correct for errors and omissions; specifically the section:

122.1. lists those adjustments made by Ofcom which BT accepts;

122.2. lists those adjustments made by Ofcom which BT does not accept and explains why Ofcom has made a mistake;

122.3. sets out and explains a number of other adjustments which are necessary; these adjustments follow a detailed review of the published figures and supporting methodology and data; and

122.4. proposes a method clearly superior to that used by Ofcom to derive proxies for those services that are in dispute and are reported within the “Other Bandwidth” category of the RFS.

123. All of the figures provided in this section are total DSAC amounts and not per unit amounts. The underlying figures from which they are derived can be found in Section 12 of the E1DD.

124. BT accepts, for the purposes of these Disputes, that where the material in the RFS has been superseded by more accurate figures, it would be inappropriate simply to use the DSAC figures published in the RFS, over the relevant period, to assess cost orientation and BT’s compliance with Condition HH3.1. However, where the figures in the RFS are not to be used, then Ofcom must use all the most accurate information and must make the adjustments that have the effect of increasing the published DSAC as well as those that have the effect of decreasing the published DSAC (and other) figures.

### 4.2 Adjustments Accepted

125. BT accepts, for the purposes of these Disputes, that Ofcom has made correct adjustments in respect of:

125.1. the following volume errors:

- (i) the discrepancy between the volumes used to derive component unit costs and those used to distribute component costs to services in calculating the 2006-07 and 2007-08 unit FACs and DSACs<sup>103</sup>;
- (ii) the volume errors relating to WES services in 2006-07<sup>104</sup>;
- (iii) the volume errors for BES1000 rental and BES1000 connection in 2008-09<sup>105</sup>; and
- (iv) the revenue errors associated with Main Link in 2008-09<sup>106</sup>;

125.2. excess construction charges<sup>107</sup>;

125.3. holding gains<sup>108</sup>;

125.4. the Regulatory Asset Valuation<sup>109</sup>; and

125.5. Main Link rentals in 2006-07<sup>110</sup>.

### 4.3 Adjustments not accepted

126. BT does not accept the adjustments made by Ofcom in respect of:

126.1. transmission equipment costs;

126.2. 21CN equipment costs; and

126.3. payment terms.

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<sup>103</sup> E1DD §12.43 to 12.45

<sup>104</sup> E1DD §12.46 to 12.48

<sup>105</sup> E1DD §12.49 to 12.54

<sup>106</sup> E1DD §12.55 to 12.56

<sup>107</sup> E1DD §12.79, 12.80

<sup>108</sup> E1DD §12.85 to 12.96

<sup>109</sup> E1DD §12.97 to 12.100

<sup>110</sup> E1DD §12.101 to 12.107

#### 4.3.1 Transmission equipment costs

127. Ofcom has failed to allow for the capital expenditure on transmission equipment costs in 2010-11 even though these costs have (rightly) been included in previous years. The impact of including these costs on the DSACs is shown in Table 4.1 below.

**Impact on DSAC of Including 2010-11 Transmission Equipment Capital Expenditure [C]**

DSAC adjustments £m	2010-11
BES 1000 rental	[ ]
WES 10 rental	[ ]
WES 100 rental	[ ]
WES 1000 rental	[ ]

**Table 4.1**

128. Ofcom has already accepted, for the purposes of the E2PD and the E3PC<sup>111</sup>, that the capital expenditure on transmission equipment costs should be included in 2010-11. For consistency, this point should also be accepted here.

129. As argued below, BT considers that connections and rentals should not be viewed as separate and distinct services but this adjustment to include transmission equipment capital costs needs to be made irrespective of whether connections and rentals are considered together or separately.

#### 4.3.2 21CN equipment costs

130. Ofcom states that:

*“The objective of the adjustment is not to reflect a scenario where BT’s 21CN does not exist; it is to adjust for an incorrect allocation of 21CN costs. The direct costs of BT’s 21CN should be recovered via the services which use it. Since the Ethernet services in dispute have not used BT’s 21CN this adjustment removes those costs directly attributable to 21CN.”<sup>112</sup>*

131. Ofcom is wrong to consider the treatment of 21CN costs as a simple matter of cost allocation to be decided as if the 21CN and BES and WES services were completely unrelated. Rather the correct position is that:

131.1. the 21CN and BES and WES services are closely related services meeting the same customer need (to transmit large volumes of data at high speed) so that the 21CN

<sup>111</sup> E3PC §§5.47-5.49 and update note of 5 April 2012 to the E2PD

<sup>112</sup> E1DD §12.73

costs should be regarded as part of the forward-looking costs of providing customers with high speed data services;

131.2. the DSAC methodology is such that if the costs incurred to build and develop the 21CN are excluded from the assessment of the services in operation in the year in which the expenditure was incurred then those costs will never be taken into account in any assessment of cost orientation; and

131.3. the exclusion of 21CN costs would be inconsistent with the approach taken by Ofcom (for very good reasons) in the 2009 LLCC.

132. These points are explained further below.

#### 4.3.2.1 Closely related services

133. The 21CN and BES and WES services are closely related.

133.1. The 21CN was devised and developed to handle growing data volumes and the Ethernet services that are the subject of this dispute were deployed to meet exactly the same need. Indeed, during WES and BES pricing discussions in 2006 and 2007, Ofcom implicitly recognised this when it positively encouraged Openreach to deploy the EBD services that run over the 21CN and meet the same customer need as WES and BES. WES and BES services are now being withdrawn and customers migrated to equivalent 21CN services. This means that the eventual beneficiaries of the 21CN costs attributed to Ethernet will be the CPs who have purchased Ethernet services.

133.2. Ofcom has determined that WES and BES services and their replacement 21CN services all fall within the same regulatory market.

133.3. In the 2009 LLCC Ofcom allowed BT a “migration credit” (in effect a revenue allowance) under the RPI-X price control when customers moved from WES or BES services to new 21CN services; and

133.4. Ofcom proposes to use the costs of Ethernet Access Direct (“EAD”) and EBD services to set the proposed next charge control for the AISBO services and thus the prices for WES and BES services.



134. Put simply, investment in 21CN represents the cost of relevant development; that is, investment underpinning the future development of the Ethernet services in question. This should therefore form part of the forward looking costs of these services.

#### 4.3.2.2 Forward-looking costs and cost orientation

135. Ofcom ought also to recognise the overlap in timing for 21CN investments and continued WES and BES service provision. Replacement services cannot be introduced without up-front set-up costs and losses in initial periods, when volumes are low and unit costs high. In any future review of the prices of 21CN services, using DSAC, the early 21CN costs will, in effect, be overlooked altogether under the proposed exclusions – being deemed irrelevant at the time they are incurred and then “timed-out” in any later review. This does not give BT the right incentives to take risks and invest in new technologies and is contrary to Ofcom’s policy at the time those investment decisions were made.

136. The effect of including 21CN costs would be to increase the DSACs by the amounts shown in Table 4.2.

**Impact on DSAC of including 21CN Costs [C]**

DSAC adjustments £ m	06-07	07-08	08-09	09-10	10-11
BES 100 rental					
BES 1000 rental					
BES 100 connection				N/A	N/A
BES 1000 connection					N/A
WES 10 rental					N/A
WES 100 rental					
WES 1000 rental					
Main link rental	N/A				N/A
BES 155 rental					
BES 622 rental					
BES 2500 rental	N/A	N/A		N/A	N/A
BES 10000 rental	N/A	N/A		N/A	N/A
WES 155 rental					
WES 622 rental					
WES 10000 rental	N/A			N/A	N/A

**Table 4.2**

#### 4.3.3 Payment terms

137. Ofcom has adjusted the working capital attributed to Ethernet services so as to reflect the stated payment terms as opposed to the actual longer credit periods taken by the CPs

buying Ethernet services. Ofcom says, inter alia, that this is necessary to be consistent with the approach adopted in the 2009 LLCC.

138. This adjustment is perverse and unfair to BT. Essentially CPs are being rewarded twice for having been delinquent in their payments – they benefited by paying their bills late and now Ofcom proposes that they benefit again by assessing compliance with Condition HH3.1 on the basis that that should be regarded as having settled their bills on time. The right and fair approach would be to base the assessment on the number of days of credit actually taken.
139. Ofcom has made two adjustments for debtor days. The first is to consider the effect of treating the charges for connections and rentals separately. BT accepts that this would be appropriate if connections and rentals are to be separately treated, although as argued below, BT does not accept that it is right to treat connections and rentals as separate and distinct services. The second is to reflect the stated payments terms, rather than the actual payment period.
140. The impact on the DSACs of basing the calculations on the actual days credit taken by CPs (rather than the lesser credit they were supposed to have taken) is shown in Table 4.3 below.

### Impact on DSAC of Using Actual Payment Terms [C]

DSAC adjustments £ m	06-07	07-08	08-09	09-10	10-11
BES 100 rental					
BES 1000 rental					
BES 100 connection				N/A	N/A
BES 1000 connection					N/A
WES 10 rental					N/A
WES 100 rental					
WES 1000 rental					
Main link rental	N/A				N/A
BES 155 rental					
BES 622 rental					
BES 2500 rental	N/A	N/A		N/A	N/A
BES 10000 rental	N/A	N/A		N/A	N/A
WES 155 rental					
WES 622 rental					
WES 10000 rental	N/A			N/A	N/A

**Table 4.3**

## 4.4 Additional adjustments needed

### 4.4.1 Introduction

141. BT accepts that Ofcom is correct to adjust for errors and clearly inappropriate methodology. In order to ensure that all DSACs are correctly stated, BT has carried out additional detailed analysis of the published DSACs for the years 2006-07 to 2010-11 and has identified a number of further adjustments that need to be made to correct for errors in the published DSACs. These errors relate to:

141.1. BES fibre costs;

141.2. provisioning costs; and

141.3. ISDN2 monitoring line costs.

#### 4.4.2 BES fibre costs

142. BT has discovered an error in the calculation of BES fibre costs for the years 2006-07 to 2008-09 inclusive. The problem was that the people inputting the number of fibres used for BES services had failed to appreciate that each BES circuit has two ends and that each end uses two fibres. The consequence was that not enough fibre costs were allocated to BES in the RFS.
143. The effect of the error can be seen in Table 4.4 below which shows the unit costs for fibre included within the published RFS numbers. Please note that for 2006-07 the element of fibre costs associated with the Main Link has been excluded.

**Historic Cost Accounting (“HCA”) Unit Cost of Fibre within Published RFS Numbers [C]**

Unit costs £	2006-07	2007-08	2008-09	2009-10	2010-11
BES 100 rental	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	Not published
BES 1000 rental	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

**Table 4.4**

144. There is no reason why fibre costs should vary significantly between years, except for the volume input error.
145. Given the complexity of the ASPIRE model and the time required to re-run it in full, the unit costs for 2009-10 and 2010-11 have been used as a proxy for the missing correct values. Fibre costs should not vary significantly over time, as neither the underlying costs of fibre (excluding the current cost adjustments) nor the fibre utilisation rate would vary over this period. Indeed, the unit costs for 2009-10 and 2010-11 in Table 4.4 are stable.
146. Applying these proxies would increase the unit FAC by £[REDACTED][C] in 2006-07, £[REDACTED][C] in 2007-08 and by £[REDACTED][C] in 2008-09. The impact on the total FAC, given the volumes, is shown in Table 4.5 below.

**Impact on FAC of Correcting BES Fibre Volume Error [C]**

FAC adjustments £ m	2006-07	2007-08	2008-09
BES 100 rental	[REDACTED]	[REDACTED]	[REDACTED]
BES 1000 rental	[REDACTED]	[REDACTED]	[REDACTED]
BES 155 rental	[REDACTED]	[REDACTED]	[REDACTED]
BES 622 rental	[REDACTED]	[REDACTED]	[REDACTED]
BES 2500 rental	N/A	N/A	[REDACTED]
BES 10000 rental	N/A	N/A	[REDACTED]

**Table 4.5**

147. The fibre costs are a separate component within the LRIC model. As such LRIC : DSAC ratios are available to calculate the impact of the change in FAC on DSAC. The ratios are set out in Table 4.6.

**DSAC : FAC Ratios [C]**

Fibre component	2006-07	2007-08	2008-09
DSAC : FAC ratio	[■]	[■]	[■]

**Table 4.6**

148. Applying this ratio gives the following adjustments to the DSACs.

**Impact on DSAC of Correcting BES Fibre Volume Error [C]**

DSAC adjustments £m	2006-07	2007-08	2008-09
BES 100 rental	[■]	[■]	[■]
BES 1000 rental	[■]	[■]	[■]
BES 155 rental	[■]	[■]	[■]
BES 622 rental	[■]	[■]	[■]
BES 2500 rental	N/A	N/A	[■]
BES 10000 rental	N/A	N/A	[■]

**Table 4.7**

149. The error in under-attributing cost to BES services caused a corresponding overstatement of the costs of other services (including WES services) to which local fibre costs are attributed. However, BES services formed a very small part ([■%][C]) of the total fibre costs in each year concerned so that the consequential changes to the costs attributed to other services are not material.

**4.4.3 Provisioning costs**

150. BT has identified a number of errors in the reporting of provisioning costs arising from mistakes in the mapping of cost components to services with the result that:

150.1. provisioning costs were excluded from the published RFS figures for WES and BES connection costs for the years 2006-07 to 2007-08 inclusive;

150.2. provisioning costs were included in rentals in 2008-09, but at a lower than appropriate cost allocation; and

150.3. the provisioning costs were included in connection costs for the first time in 2009-10, but at too high a cost.

151. Provisioning costs in 2010-11 were £[REDACTED][C] per unit, a figure that has been re-checked. The unit cost of service provision will not have varied materially over time and hence this can be taken as appropriate proxy for the previous years and used to correct the published DSACs by substituting this amount for the amount in the published figures for the years 2006-07 to 2009-10 (inclusive).
152. Table 4.8 shows the adjustments needed to the FAC costs attributed to connections and rentals.

**Impact on FAC of Correcting Errors in Provisioning Costs [C]**

FAC adjustments £m	2006-07	2007-08	2008-09	2009-10
BES 100 rental	[N/A	N/A		N/A
BES 1000 rental	N/A	N/A		N/A
BES 155 rental	N/A	N/A		N/A
BES 622 rental	N/A	N/A		N/A
BES 2500 rental	N/A	N/A		N/A
BES 10000 rental	N/A	N/A		N/A
BES 100 connection				
BES 155 connection				
BES 1000 connection				
WES 10 rental	N/A	N/A		N/A
WES 100 rental	N/A	N/A		N/A
WES 1000 rental	N/A	N/A		N/A
WES 10 connection				
WES 100 connection				
WES 155 connection				
WES 1000 connection				

**Table 4.8**

153. Again the DSAC : FAC ratio is available and is shown in Table 4.9.

**DSAC : FAC Ratio [C]**

	2006-07	2007-08	2008-09	2009-10
DSAC: FAC ratio	[REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

**Table 4.9**

154. Applying the ratio to the costs gives the adjustments to DSAC set out in Table 4.10 below.

**Impact on DSAC of Correcting Errors in Provisioning Costs [C]**

	2006-07	2007-08	2008-09	2009-10
BES 100 rental	[N/A	N/A	■	N/A
BES 1000 rental	N/A	N/A	■	N/A
BES 155 rental	N/A	N/A	■	N/A
BES 622 rental	N/A	N/A	■	N/A
BES 2500 rental	N/A	N/A	■	N/A
BES 10000 rental	N/A	N/A	■	N/A
BES 100 connection	■	■	■	■
BES 155 connection	■	■	■	■
BES 1000 connection	■	■	■	■
WES 10 rental	N/A	N/A	■	N/A
WES 100 rental	N/A	N/A	■	N/A
WES 1000 rental	N/A	N/A	■	N/A
WES 10 connection	■	■	■	■
WES 100 connection	■	■	■	■
WES 155 connection	■	■	■	■
WES 1000 connection	■	■	■	■]

**Table 4.10**

#### 4.4.4 ISDN2 monitoring lines

155. ISDN2 lines are used to monitor certain WES and BES services for faults.<sup>113</sup> The ISDN2 monitoring line is for the provision of providing WES and BES to multiple customers and therefore is a supply cost. The costs of the ISDN2 lines should therefore be added to the costs of the relevant WES and BES services to fairly reflect the costs of providing the services. As the result of an oversight, this was not done in the RFS.

<sup>113</sup> See BT supplier information notes ("SIN"), SIN 431 to 448 and 459 to 463 at: [www.btwebworld.com/sinet](http://www.btwebworld.com/sinet)

156. The necessary adjustments are shown in Table 4.11.

**Impact on DSAC of Including Missing ISDN2 Costs [C]**

DSAC adjustments £ m	06-07	07-08	08-09	09-10	10-11
BES 100 rental	█	█	█	█	N/A
BES 1000 rental	█	█	█	█	█
BES 100 connection	█	█	█	N/A	N/A
BES 1000 connection	█	█	█	█	N/A
WES 10 rental	█	█	█	█	N/A
WES 100 rental	█	█	█	█	█
WES 1000 rental	█	█	█	█	█
Main link rental	N/A	N/A	N/A	N/A	N/A
BES 155 rental	█	█	█	█	█
BES 622 rental	█	█	█	█	█
BES 2500 rental	█	█	█	█	█
BES 10000 rental	█	█	█	█	█
WES 155 rental	█	█	█	█	█
WES 622 rental	█	█	█	█	█
WES 10000 rental	█	█	█	█	█
WES 10 connection	█	█	█	█	N/A
WES 100 connection	█	█	█	█	█
WES 1000 connection	█	█	█	█	█

**Table 4.11**

#### 4.4.5 Better proxies

157. In the Ethernet 2 Provisional Determination Ofcom uses proxies to derive the costs of bandwidths that are not calculated or disclosed separately in the RFS.

158. It is possible to derive a more accurate proxy for the costs of other bandwidths than that used by Ofcom by better allowing for the fact that while many costs (such as fibre) are bandwidth independent, electronic costs do vary with bandwidth (suppliers charge more for higher speed electronics).

159. BT has therefore taken the 100Mbit/s and 1000Mbit/s services for which it has costs, identified the proportion of these costs that is made up of electronics and then upgraded the electronics costs to reflect the higher (or lower) speeds of the other services.



160. The ratios for the different services and years are shown below.

**Electronics Equipment Ratios [C]**

Bandwidth (Mbit/s)	2006-07	2007-08	2008-09	2009-10	2010-11
100	[■]	■	■	■	■
155 (100 as base)	■	■	■	■	■
155 (1000 as base - BES only)	N/A	N/A	N/A	N/A	■
622 (100 as base)	■	■	■	■	■
622 (1000 as base - BES only)	N/A	N/A	N/A	N/A	■
1000	■	■	■	■	■
2500 (1000 as base)	■	■	■	■	■
10000 (1000 as base)	■	■	■	■	■]

**Table 4.12**

161. Applying these ratios to the costs gives the additional electronic costs set out in Table 4.13 for the services that are not separately published.

**Impact on DSAC of Using Better Proxies [C]**

DSACs adjustments <sup>114</sup> £m	2006-07	2007-08	2008-09	2009-10	2010-11
BES 155	[■]	■	■	N/A	■
BES 622	N/A	N/A	N/A	N/A	■
BES 2500	NID*	NID	■	NID	NID
BES 10000	NID	NID	■	NID	NID
WES 155	■	■	■	■	■
WES 622	■	■	N/A	■	■
WES 10000	NID	■	■	NID	NID]

**Table 4.13**

\*NID = Not in Dispute

**4.4.6 Conclusion**

162. Various adjustments have been identified that should be made to the published figures to correct errors and apply better proxies. These adjustments are on a par to those identified by Ofcom – they correct errors in the published RFS and clearly whether an error serves to increase or decrease costs is irrelevant. An error is an error, what matters is that the correct figures or best available data are used.

<sup>114</sup> 2006-07 to 2009-10 adjustments are connection adjustments; 2010-11 is a rental adjustment.

## 5 Connections and Rentals

### 5.1 Introduction

163. In assessing the amount by which it is proposing to find BT to have over-charged for Ethernet services, Ofcom has treated connections and rentals as if they were separate services (i.e. individual forms of network access (services) to which Condition HH3.1 applies) with separate charges that had to be separately cost orientated and compliant with Condition HH3.1. This approach is wrong. Connections and rentals are rather two different aspects of the charge for a single service, (this single service being the network access). This is evident from the names given to the products – they are Wholesale Extension *Services* and Backhaul Extension *Services* for which connection and rental tariffs are charged.
164. This section explains why Ofcom’s proposal to treat connections and rental as separate and distinct services is wrong and, specifically that, Ofcom’s approach:
- 164.1. is based on a misunderstanding of and hence misapplication of the PPC Judgment;
  - 164.2. is based on giving too much weight to the fact that separate prices are published in the Openreach Price List (“the OPL”) and separate lines reported in the RFS;
  - 164.3. is based on a faulty analysis of the impact on customers;
  - 164.4. is inconsistent with best accounting practice;
  - 164.5. is inconsistent with normal commercial practice in competitive markets;
  - 164.6. is more likely than not to produce unintended and unwanted consequences;
  - 164.7. is inconsistent with Ofcom’s own previous practice; and was made without the support of any preceding regulatory guidance (as made clear in Section 3 above).
165. Therefore to treat connections and rentals as separate services is plain wrong and unfair to BT.

## 5.2 Misreading of the PPC Judgment

166. In the appeal of the PPC1 FD (“the PPC Appeal”) the CAT was concerned with whether charges for different bandwidths and Trunk and terminating segments each had to be separately cost orientated and compliant with Condition H3.1. Ofcom itself makes this clear in the emphasis it added to a quotation from the PPC Judgment<sup>115</sup>:

*“According to Condition H3.1 “each and every charge offered” must be cost orientated. We consider that the effect of these words is to render the test for cost orientation applicable separately to each discrete trunk service – i.e. the charge for each bandwidth must be cost orientated”*

[Emphasis added by Ofcom]

167. Ofcom further quotes the CAT as saying that this construction “makes sense” because the purchaser of any particular service<sup>116</sup>, “... will want to know that the particular service he is buying is cost orientated. He will doubtless be rather less concerned with the cost orientation for services he is not purchasing.”<sup>117</sup>
168. In the PPC 1 Appeal the CAT was considering the correct treatment of prices for services that differ in their technical characteristics (i.e. how fast they run and how far they extend into the core network). Different customers choose between different bandwidths depending on how much traffic they have to carry, and different ratios of trunk to terminating segment depending on how extensive their own networks are.<sup>118</sup>
169. But there are no such technical differences between connections and rentals – there is just one service for which a connection and a rental price are published. Customers are not choosing between connections and rentals, rather the opposite is the case and customers are electing to purchase access to the network, a service for which both connection and rental prices are payable. No customer has ever wanted, or would ever want, to purchase a connection without also purchasing a rental (why would any customer want to pay to connect to a network it had not paid to be allowed to use?). Nor would any customer be allowed to pay a rental to use a service without having first paid the connection fee.

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<sup>115</sup> E1DD §8.10

<sup>116</sup> E1DD §8.11

<sup>117</sup> E1DD §8.11

<sup>118</sup> The very reference by the CAT to service (equating the charge with that of the service) demonstrates that an overly granular focus on individual prices in a price list cannot per se form a service.

170. On the one hand, terminating and Trunk segments run over distinct and separate parts of the physical network infrastructure and different bandwidths make different use of the network transmission electronic equipment. On the other hand, connections and rental are different elements of the charge for one individual service that runs over the same physical network infrastructure and offers one defined speed.
171. The CAT observed that a purchaser would not be concerned with the cost orientation of a service which he is not buying; the reality is that purchasers of BES and WES services buy services that necessarily include both connection and rental so that what matters to them is the cost orientation of connection and rental when taken together.

### 5.3 Too much weight on publication in the OPL and RFS

172. In deciding whether or not to disaggregate a charge for an Ethernet service into connections and rentals, Ofcom places substantial weight on the fact that connections and rentals are separately identified in the OPL and RFS:

*“...BT charges for connections and rentals separately: we note that these charges are listed as separate items in the Openreach Price List, and that the connection charge is a one off charge whereas the rental charge is recurring. Given the wording of Condition HH31, we place substantial weight on this fact”<sup>119</sup>*

and

*“...connections and rentals have been reported separately in the RFS since 2006/07. Connection and Rental charges have different costs associated with them and, in the LRIC model, connections and rentals have different underlying network components”<sup>120</sup>.*

173. No conclusions should be drawn from there being separate price list entries. Connection and rental prices are different elements of the charge for a single service (network access) and this also requires that both connection and rental prices be published in the OPL.<sup>121</sup>
174. Nor should conclusions be drawn from the fact that the RFS shows data for connections and rentals separately. 1. The RFS provides information that can be used to assess cost orientation (and therefore assumed compliance with Condition HH3.1, since that is one of

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<sup>119</sup> E1DD \$8.70

<sup>120</sup> E1DD \$8.71

<sup>121</sup> BT speculates that had BT termed its prices “first year” and “continuing” prices, Ofcom would have reached a different conclusion and that Ofcom seems to be giving too much weight to the fact that different nouns are used to name each price forming part of the charge.

the expressed purposes of the RFS) but the format (as opposed to the content) of the RFS does not in itself determine compliance with cost orientation or the basis on which compliance is to be assessed.

175. For large elements of the costs attributed to Ethernet services, including WES and BES services, it is largely a matter of subjective judgement as to whether a cost is attributed to “connections” or “rentals”, i.e. it is arbitrary. For example, the costs of electronic equipment were attributed to connections in the years up to 2009-10 but attributed to rentals in 2010-11. Ofcom has accepted that either methodology would be appropriate (and has not reattributed these costs as part of its proposed adjustments)<sup>122</sup>. This is a strong indication that connections and rentals are not separate and distinct services (that is to say separate and distinct forms of network access), each with their own independent cost functions, but rather different parts of the same charge for a single service.

#### 5.4 Incomplete analysis of impact on customers

176. Ofcom argues that aggregating connections and rentals could give rise to cross-subsidisation between customers:

*“.....aggregation of all rental and connection charges for each bandwidth within a financial year could give rise to distorted price signals and cross-subsidisation between different groups of customers.”<sup>123</sup>*

*“For example, if rental charges were “too high” but connection charges are “too low”, such that over one year the aggregate revenues are below cost and over two years the aggregate revenues are above cost, then the CP purchasing the two year circuit will be facing a charge which is cross-subsidising the CP purchasing the one year circuit”<sup>124</sup>.*

177. Ofcom then suggests that this is in fact the case based on snap-shot analysis showing the connections and rentals paid by the Disputing CPs in 2007-08<sup>125</sup>. This analysis fails to represent the full underlying picture. In particular, by showing only one year the data primarily reflects the different stages the CPs had reached, by 2007-08, in purchasing new circuits to expand their networks. The data does not show the situation in other relevant

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<sup>122</sup> E2PD §§ 5.69 to 5.75

<sup>123</sup> E1DD §8.73

<sup>124</sup> E1DD §8.74

<sup>125</sup> E1DD Fig. 8.2

years of the Disputes, when those spending proportionately more on rentals in 2007-08 will have spent proportionately less.

178. From its billing records, BT has therefore analysed the buying patterns over time of the four largest external customers. This shows clearly that:

178.1. there are marked differences between the CPs as to when they purchased the their Ethernet services, presumably reflecting differences in how far and how fast they chose for various reasons to roll-out their networks; further it is worth noting that while all the CPs bought BES services, [REDACTED]  
[REDACTED] [C]; and

178.2. there are no systematic differences between CPs in terms of how long on average their circuits have been active – the average ages of the circuits ceased in any year are closely clustered.

179. The clear conclusion is that the single year picture that Ofcom shows in Figure 2 is not representative of the position over the period of the Disputes in full.

180. Charts for each of the circuits covered by the Disputes are set out at Annex B [C].

181. Below we give just the charts for BES 100 connections. Figure 1 shows, for each of the CPs, the proportion of total BES 100 connections purchased in each year (i.e. each line in the chart sums to 100%). This shows that:

181.1. [REDACTED];

181.2. [REDACTED]  
[REDACTED]; and

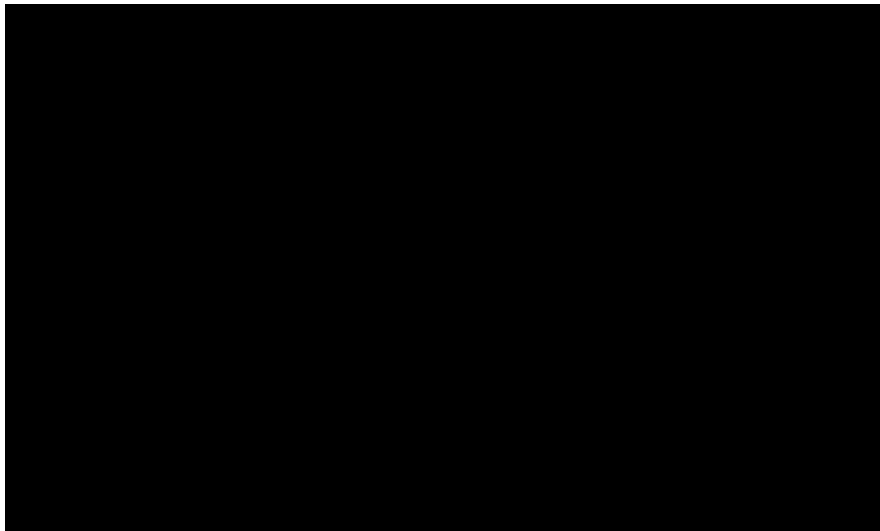
181.3. [REDACTED] [C]

182. There are no grounds for supposing this pattern was in any way driven by the relative pricing of connections and rentals.



**Figure 1 [C]**

183. Figure 2 shows the average age of circuits ceased in any given year by CP. The size of the circles indicates the volume of cessations. This shows strong clustering with no systematic differences between CPs.



**Figure 2 [C]**

184. So there is no evidence from CPs' purchasing patterns that the relative pricing of connections and rentals has systematically affected CPs' buying patterns nor that it has systematically advantaged or disadvantaged any CP. (But it is clear that treating connections and rentals as separate and distinct services would now unduly systematically benefit the Disputing CPs and unduly penalise BT).
185. Moreover, Ofcom needs to be careful not to unwittingly and unduly extend the scope of the basis of charges obligation. Condition HH3.1 refers to "*each and every charge [for a service]*" but it does not refer to "*each and every charge [for a service] for each and every customer*" and it should not be read as if it did.
186. It is a normal feature of competitive markets, including the AISBO market, that it will cost less to provide service to one customer contrasted with another, and that as a result, if the cost, revenue and margin were to be examined at the level of the individual customer per unit provided, a different margin may be earned from one compared to the other. Likewise, different margins may be earned from different customer segments, for the same services. Indeed, the only way to ensure that there is no variability of margin across and no cross-subsidisation between customers would be to prescribe tightly how prices must be set (for example, to require that every cost must be recovered in the year in which it was incurred so that all the provisioning and electronics costs were recovered in an up-front charge) but this would be at odds with the avowed intent of the basis of charges obligation, namely of allowing BT a substantial measure of freedom over how it recovers its costs.

## 5.5 Inconsistent with best accounting practice

187. Treating connections and rentals as separate charges for network access is inconsistent with the best accounting practice.
188. In November 2011 the International Accounting Standards Board issued an Exposure Draft setting out a proposed new accounting standard on "*Revenue from Contracts with Customers*" (ED/2011/6).<sup>126</sup> This sets out best practice in accounting for different types of customer revenue and is directly relevant as to whether connections and rentals should be

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<sup>126</sup> [http://www.ifrs.org/nr/rdonlyres/f88d0071-39a5-41d8-9374-a6355927f459/0/revrec\\_edii\\_standard.pdf](http://www.ifrs.org/nr/rdonlyres/f88d0071-39a5-41d8-9374-a6355927f459/0/revrec_edii_standard.pdf)



considered as separate charges or as two-part pricing tariff forming a single charge for a single service.

189. Paragraph 28 of the Exposure Draft states that:

*“ ... a good or service is distinct if either of the following criteria is met:*

*(a) the entity regularly sells the good or service separately; or*

*(b) the customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer. Readily available resources are goods or services that are sold separately (by the entity or by another entity) or resources that the customer has already obtained (from the entity or from other transactions or events).”*

190. It is clear that the Exposure Draft does not consider the connection and rental of a telecommunications circuit as distinct services as they are neither sold separately nor could a customer benefit from either on its own. A circuit that was connected to a customer but then not kept switched on would be of no benefit to a customer, nor would be a circuit that was switched on but not connected.

191. The Exposure Draft gives a specific example to clarify this point:

*“IG73. Example 16.*

*An entity enters into a contract with a customer for one year of transaction-processing services. The entity charges the customer a non-refundable upfront fee in part as compensation for the initial activities of setting up the customer on the entity’s systems and processes. The customer can renew the contract each year without paying the initial fee.*

*The entity’s setup activities do not transfer any service to the customer and, hence, do not give rise to a performance obligation. Therefore, the entity recognizes as revenue the initial fee over the period that it expects to provide services to the customer, which may exceed the one year of the initial contract term”*

192. From this example, it is clear that under the Exposure Draft a set-up or connection fee is not a fee for the transfer of any service but an integral component part of the contract and should be accounted for in the same way as the rental charges of the service, i.e. recognised over the expected contract life.

193. In this context, BT notes that COLT (which was a party to the PPC Disputes) already accounts for connections and rentals in this way – it defers installation fees and recognises them over the expected life of the customer contract.<sup>127</sup>
194. Moreover, BT has for example in the financial year 2007, for the purposes of dealing with the differences between International Financial Reporting Standards (the “IFRS”) as adopted by the European Union and United States Generally Accepted Accounting Principles (“US GAAP”), recognised an adjustment in respect of Openreach products which have significant connection and installation service charge such that the associated revenue is recognised over the estimated customer life and the costs directly associated with the revenue are deferred.<sup>128</sup>
195. It is true that the new accounting standards have not yet been adopted but even though the principles it sets out are not yet mandatory they remain an indicator of best practice, namely that connections and rentals should be aggregated and not considered separately. Put differently, if Ofcom were to continue to treat connections and rentals as distinct charges and not as part of a two-part charge for a single service it would be setting its judgement against the collective wisdom of the global accounting profession.

## 5.6 Inconsistent with normal commercial practice

196. Treating connections and rentals as separate and distinct charges is inconsistent with normal commercial practice in competitive markets. To give one obvious example, in the retail mobile market, contract customers customarily pay a monthly charge and are provided with a handset with no upfront cost. The connection cost (including the cost of the handset and SIM card) is in effect recovered over the contract period.

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<sup>127</sup> “Installation fees are deferred and recognised in the consolidated income statement over the expected length of the customer relationship period (typically three to five years) or the contractual period, if longer.” Extract from “Basis of Preparation and Principal Accounting Policies” Colt Group S.A. 2011 Annual Report p73.

<sup>128</sup> See BT’s 2007 annual report (<http://www.btplc.com/report/Report07/pdf/AnnualReport2007.pdf>), which states at paragraph 35 (page 134): “Under IFRS, IAS 18 ‘Revenue’ connection and installation services revenue is recognised when it is earned, upon activation. Under US GAAP, SAB 104 ‘Revenue Recognition’ such revenues are recognised over the estimated customer life and the costs directly associated with the revenue are deferred. Accordingly, an adjustment has been recognised for the first time in the 2007 financial year in respect of Openreach products which have a significant connection and installation service charge.”

197. It is inconceivable that any would-be purchaser of any service would evaluate the purchase by just considering the connection or just the rental price.<sup>129</sup> Likewise, no supplier would ever set a connection price in isolation from a rental price or vice versa.
198. BT does not consider that there is any regulatory prohibition on Ofcom in taking a similarly rounded view as to rental and connection prices, thus reflecting the commercial reality.

## **5.7 Likely to produce unintended and unwanted consequences**

199. Further, any policy which assesses a connection price in isolation from the subsequent rental price is likely to have unwanted and unintended consequences.

199.1. It would effectively prohibit BT from ever offering connections at below a DLRIC 'price floor' even where this would aid migration from an older platform (and set of legacy services) to new services which are likely to be cheaper to provide and offer customers an improved service. Not to recognise that connection charges are themselves often a barrier to switching would be to disregard a fundamental fact of business behaviour and commercial reality.

199.2. Further, there are good reasons to believe that setting lower upfront margins than on-going margins for Ethernet services contributed to the effective roll-out of LLU services by reducing the up-front capital requirements of the un-bundlers at a time when they were incurring heavy investment to roll-out their networks (and it is also the case that it is often easier for businesses to get approval for recurrent than one-off expenditure). In this way, competition has been increased in the downstream markets (in particular, for retail broadband services) and has been fully aligned with Ofcom's principal duty and its policy goals. As Ofcom is obliged to have regard to its statutory obligations in resolving disputes, inter alia to consider the likely impact on competition and consumers, this is clearly relevant to its assessment.<sup>130</sup>

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<sup>129</sup> This is especially the case when, as with WES and BES connections, a minimum term applies following connection.

<sup>130</sup> Further, the only published guidelines on cost orientation explicitly refer to these effects, as noted in the E1DD §4.9.

## 5.8 Inconsistent with Ofcom's past practice

200. Ofcom's approach to the aggregation of connections and rentals in this dispute is inconsistent with:

200.1. Ofcom's past practice, in particular with its approach to setting starting charges for the 2009 LLCC; and

200.2. the response to a specific question as to how Ofcom would treat connections and rentals for the purpose of assessing cost orientation.

201. The approach Ofcom has now taken with regard to connections and rentals was also never explained to BT (see BT's comments regarding uncertainty in section 3.4).

### 5.8.1 Starting charges for the 2009 LLCC

202. In setting the starting charges for the 2009 LLCC, Ofcom took a combined view as to the level of connections and rentals. In the Draft Determinations, Ofcom explains that:

*"In that case [making a starting charge adjustment to BES 1000 rental], we established the appropriate level of the starting charge for BES1000 rental by comparing the aggregate connection and rental prices over the contract life of an AISBO circuit (assumed to be three years) to the aggregate of our adjusted DSAC values for these services. We explained that in considering possible start charge adjustments, we had looked at BT's rental and connection costs (for each BES and WES service) together, as those charging elements fall in the same economic market; BT's wholesale customers would necessarily consume them together; and it is not always clear what the optimal structure of charges is, and what the balance should be between up front (connection) and recurring (rental) elements for efficient recovery of costs."<sup>131</sup>*

203. Ofcom further asserts that at the time it had, nevertheless, not taken "a definitive position" regarding BT's compliance with its basis of charges obligation, but that the starting price adjustments reflected its interpretation of the requirement based on the information available to it at the time.<sup>132</sup> Ofcom goes on to state that it is not now "required" to take

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<sup>131</sup> E1DD §8.64

<sup>132</sup> E1DD §8.64

the same approach to assessing compliance with BT's cost orientation obligations;<sup>133</sup> and that the two exercises (setting starting charges and assessing cost orientation) are distinct regulatory exercises.

204. Ofcom is wrong to draw such a sharp and significant distinction between setting charges at the beginning of a price control and assessing cost orientation.

204.1. Both price controls and cost orientation originate from the same Article in the Access Directive, "*Price Control and Cost Accounting Obligations*".<sup>134</sup> Both are imposed to address the same issue, this being "*situations where a market analysis indicates that a lack of effective competition means that the operator concerned might sustain prices at an excessively high level, to apply a price squeeze, to the detriment of end-users*".<sup>135</sup> Both are also to be assessed by the same cost accounting system.

204.2. It would be perverse for Ofcom to set price controls (including the starting level of charges) without giving any thought to their cost orientation.

204.3. The general purpose of both of the two controls is to ensure that BT's charges are consistent with those that would be charged if the market in question was competitive.

205. Ofcom identifies some differences between the factors to be considered in setting charge controls and assessing cost orientation:

205.1. in setting starting charges Ofcom needs to consider "*competing efficiency assumptions*"<sup>136</sup> (which are additional to considerations for cost orientation);

205.2. starting charges rely on data which may be two years or more old by the time the price control starts and thus may therefore not necessarily reflect costs when the starting charges come into force<sup>137</sup>; and

205.3. a charge above DSAC may be cost orientated.<sup>138</sup>

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<sup>133</sup> E1DD §8.65

<sup>134</sup> Article 13, AI Directive

<sup>135</sup> Article 13.1, AI Directive

<sup>136</sup> E1DD §8.62

<sup>137</sup> E1DD §8.66.1

<sup>138</sup> E1DD §8.66.2

206. But Ofcom offers no explanation of why these differences are sufficient to override the considerations set out in paragraph 8.64 of the Draft Determinations and to justify a wholly different approach when assessing cost orientation from that used when setting charge controls.
207. For example, the impact on incentives to improve efficiency, then it should be noted that:
- 207.1. the Access Directive also recognises the need to consider the promotion of efficiency under cost orientation (which therefore includes the impact on productive efficiency<sup>139</sup>); and
- 207.2. if Ofcom were concerned about undermining incentives for cost reduction under cost orientation, then this could be accommodated in its cost orientation assessment, given that Ofcom is explicit that there is flexibility/latitude around the level of charge which is cost orientated.
208. Regarding the fact that starting charges rely on data which may be two years or more old by the time the price control starts, Ofcom can and does adjust the base year to reflect known cost trends or likely movements going forward. The assessment is simply made prospectively and the question of 'what data may be available' is not at all linked to whether it is right in principle to combine rentals and connections (using the best data available at the time) in assessing charges.
209. More generally, *even if* there are further efficiency considerations, and *even if* the data used for starting charge adjustments is not contemporaneous, and *even if* DSAC is not determinative of cost orientation, then it is still the case that (as Ofcom identified in paragraph 8.64 of the Draft Determinations):
- 209.1. connections and rentals fall in the same economic market;
- 209.2. connections and rentals are necessarily consumed together; and
- 209.3. there will be uncertainty about what should be the balance between up front and recurring elements for the efficient recovery of costs.

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<sup>139</sup> Efficiency is in part about producing goods and services as cheaply as possible. This is known as 'productive efficiency'. A5.29, Charge control review for LLU and WLR services, Consultation, 31 March 2011.

210. In short, none of the points made by Ofcom affect the understanding and description of the market, which is the same whether or not Ofcom is considering price controls or cost orientation obligations.
211. Far from giving any explanations as to why the differences between the setting of charge controls and the assessing of cost orientation makes the considerations identified in paragraph 8.64 of the Draft Determinations irrelevant, Ofcom's view seems to be simply that *"we do not need to be consistent and have discretion to assess closely related matters in a wholly different way if we choose"*.<sup>140</sup> This though would be to misread Ofcom's duties. Good regulation requires that regulators be consistent and transparent and justify their decisions, especially departures from past precedents.

### 5.8.2 Ofcom's 6 December Letter

212. As reported in the Draft Determinations, Ofcom wrote to BT on 6 December 2010 to say:

*"With regard to the question of connections and rentals, we recognised in the PPC appeal that it made sense to look at services together if they are bought in fixed proportions. Connections and Rentals have an element of fixed proportions through minimum contract periods, although there is also a variable element as contract periods vary. This is one of the issues we would be likely to consider in an assessment of cost orientated charges for those WLA services which are subject to the cost orientation obligation"*

213. Crucially, this letter was:

213.1. written after the PPC Judgment had been published, when Ofcom was in a position to determine how it would assess cost orientation in future in the light of this judgment; and

213.2. instrumental in persuading BT not to appeal both the WLA and WBA charge controls.

214. Ofcom gives no reasons for not following the approach set out in the 6 December Letter. It simply states that it is *"not precluded from exercising its discretion"*<sup>141</sup> but this approach would have the effect of making its communications worthless outside of formal or

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<sup>140</sup> The argument of Humpty Dumpty in "Alice Through the Looking Glass" springs to mind: "When I use a word," Humpty Dumpty said, in rather a scornful tone, "it means just what I choose it to mean—neither more nor less".

<sup>141</sup> E1DD §8.76

statutory Statements, Notices and Directions. Moreover, the real point is not whether or not Ofcom has discretion but whether or not it is exercising this discretion reasonably and consistently. Ofcom further says that the letter is irrelevant because it was issued after the period covered by the dispute<sup>142</sup>. This is beside the point which is that this letter and Ofcom's decisions in setting starting charges both show that both BT and Ofcom believed that it was sensible to consider connections and rentals together when assessing cost orientation and is an expression of Ofcom's view of its policy, which Ofcom maintains has not changed since the 2001 Guidelines. A full copy of the letter is at Annex A.

215. Although Ofcom seeks to minimise the importance of this letter, it was taken by BT as clearly indicating that combining connection and rental component prices to give the relevant charge for the network access in question, was very much a possibility. In this respect it is important to understand the context in which the letter was written.
216. Ofcom had recently completed two market reviews: the Wholesale Broadband Access market review and the Wholesale Local Access market review. These market reviews were published on the 3 December 2010 and 7 October 2010 respectively. Both markets reviews imposed basis of charges obligations in the same terms as that imposed for PPC Trunk segments. BT was very much alive at that time to the new significance that the basis of charges condition was receiving. As a result of this new significance, BT was actively considering appealing the imposition of the imposed basis of charges conditions, in those terms, to the CAT. Indeed BT had instructed external counsel and the preparation of BT's notice of appeal and supporting evidence, well advanced at the time the 6 December Letter was written.
217. Ofcom was well aware of BT's concerns and that BT was actively preparing to appeal. BT and Ofcom discussed what comfort Ofcom could provide BT so as to avoid the need for an appeal. Against this backdrop should be absolutely clear to Ofcom that BT relied upon the 6 December Letter as meaning that connections and rental prices may be viewed together for the purpose of both demonstrating and assessing compliance with the basis of charges obligation.
218. Further, the fact that Ofcom was minded to write this letter clearly indicates that Ofcom's policy was not closed to the combining of connections and rentals, but rather Ofcom was positively open to considering this. Given that the CAT's PPC Judgment does not prevent

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<sup>142</sup> E1DD §8.79



the combining of connection and rental prices to give the charge for the network access in question, that Ofcom has changed its policy or failed to apply it without any proper consultation and on a historic retrospective basis, shows poor regulatory practice and is clearly inappropriate.

## 5.9 Conclusion

219. Ofcom has misinterpreted the CAT's PPC Judgment.
220. The CAT did not conclude that each and every charge in the price list needed to be individually compliant with the basis of charges condition. The CAT only concluded that:
- 220.1. charges for products falling within different regulatory markets should not be aggregated; in terms of the PPC 1 Appeal, the CAT concluded that it was inappropriate for BT to aggregate Trunk charges, falling within the Trunk market, with charges for terminating segments, falling within the TISBO market; and,
- 220.2. it was inappropriate to aggregate services provided at different bandwidths, for example 2Mbit/s trunk with 144Mbit/s trunk services.
221. The network access<sup>143</sup> in question in the PPC 1 Appeal was therefore the charge for the Trunk, at a specific bandwidth, i.e. 2Mbit/s Trunk segments alone – in the Trunk market, at each individual bandwidth, there being only one charge.<sup>144</sup> Specifically, the CAT expressed no view as to whether individual component prices, forming together a specific service, at a specific bandwidth have to be treated as disaggregated charges, where those prices fall within one regulatory market.
222. Ofcom must therefore consider in the context of these Disputes what is the network access in question and therefore what is the applicable charge.

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<sup>143</sup> In the PPC Judgment the CAT concluded, "225. ... *If the definition of Network Access were confined to meaning "interconnection of public electronic communications networks" there might be some force in this, but it is plain that "Network Access" has a much wider meaning than this, extending to (for example) "any apparatus comprised in such a network or used for the purposes of such a network or service". It plainly can include a 2 Mbit/s trunk segment without other segments that might make up the circuit.* 226. Accordingly, we conclude that Condition H3.1 – on its true construction – applies to trunk services alone. ...

228. According to Condition H3.1, "each and every charge offered" must be cost orientated. We consider that the effect of these words is to render the test for cost orientation applicable to each discrete trunk service – ie [sic] the charge for each bandwidth must be cost orientated." [Emphasis added. Note the focus here on different parts of the network used to provide discreet services at specific bandwidths.]

<sup>144</sup> PPCs Trunk segments do not have a two-part price; there is only one price for the PPC Trunk segment charge.

223. BT accepts for the purpose of these Disputes, that it is appropriate to look at:
- 223.1. each bandwidth individually<sup>145</sup>, e.g. 10 Mbit/s separately from 100 Mbit/s;
  - 223.2. different service types separately, e.g. WES separately from BES; and
  - 223.3. Main Link separately from other services (here there is a close parallel between considering trunk and terminating segments separately).
224. But it is not appropriate to look at connection and rental(s) separately; to do so would be at odds with accounting standards, normal commercial practices and customers' buying patterns; and would be deeply unfair to BT. The plain fact is that connections and rentals are always purchased together. It is not even theoretically possible – as was the case with 2 Mbit/s Trunk PPC segments – to rent a service without having a connection or vice versa. Connection and rental prices are two different elements of the charge for the same network access.

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<sup>145</sup> However, as part of an overall assessment of compliance it also necessary to consider the individual charges for network access within the context of the portfolio of products within which the service sits; specifically, it is necessary to consider the charge in question's relationship with other associated charges.

## 6 DSAC Errors

### 6.1 Introduction

225. For the purposes of these Disputes, as recognised by Ofcom in Section 11 of the Draft Determinations, BT considers that it would be inappropriate to use the DSAC figures published in the RFS, over the relevant period, to assess cost orientation and BT's compliance with Condition HH3.1. Put simply, the published DSACs are wrong as they reflect a process in which, for certain components, the value of duct under the DSAC methodology is significantly less than (in some cases under half) the FAC value. There is no economic rationale for this result, which is simply perverse.
226. BT realised that there were errors in the published DSACs when it observed that one DSAC was below FAC and a number of other DSACs were only a little above FAC. These results are anomalous and indicate clearly that the model used to calculate DSACs is not working as it should. DSAC is intended to represent the (distributed) standalone cost of producing a sub-set of a business' products, without producing the rest of the business' products. In a business such as telecommunications where there are substantial economies of scale and scope, the cost of producing a subset of products in isolation will be substantially greater than the cost of producing those products alongside the rest of the business' output. This is clearly the intended relationship which gave rise to DSAC as a first order price ceiling.
227. It is wrong for a regulator to reject any consideration of the most up to date figures, regardless of the precise reason why exactly the new figures are more accurate.
228. However, even if it were a necessary requirement to show some mathematical error (as Ofcom suggests, see paragraph 11.57 of the Draft Determination), it is worth stressing here that the results are mathematically wrong. It is a mathematical error to use the wrong formula to produce a desired result – you cannot find the area of a circle by multiplying its diameter by Pi, even if the arithmetic is faultless.
229. Moreover, because the published numbers are wrong they do not serve the stated purpose of Ofcom's approach to cost orientation, namely of giving BT the intended "*bounded flexibility*" over how it recovers its costs.

230. BT investigated why these results were so odd and discovered that the model had been set up so that costs that were specific to local duct and fibre were being attributed in large part to core activities. This appears to be a simple error, for which BT has been unable to find any explanation. Certainly there is no good economic or accounting reason for adopting such an approach. This error has now been corrected and from 2011/12 onwards the RFS has been calculated on the alternative correct method put forward by BT (and accepted by Ofcom<sup>146</sup>).
231. BT's position is therefore straightforward. The published numbers are wrong and Ofcom must use the adjusted numbers (calculated according to the alternative methodology accepted as correct by Ofcom) in assessing cost orientation.
232. The changes needed to the published DSACs are as valid as the other adjustments Ofcom has made. It might be said that the errors in the published numbers should have been discovered earlier. Clearly it would have been better had they been but they were not. In truth the calculation of the DSACs received too little attention by BT and others until the rash of disputes made their significance clear. This said this is no reason not to use the right, corrected numbers just as it is right to correct for other errors in the published RFS.

## 6.2 Ofcom's Position

233. In the Draft Determinations, Ofcom explained that in its view:

*"The methodology generates DSACs consistent with the policy objective that they are designed to address and does so in a way that appears to have a reasonable economic justification. We have not found any evidence that BT's existing approach is inconsistent with BT's published LRIC methodology, the NCC Guidelines or Geoffrey Myers' witness statement in the PPC appeal."*<sup>147</sup>

234. Ofcom reached this conclusion on the basis that:

234.1. DSAC being below FAC does not necessarily imply that the DSAC figures are incorrect or inappropriate, given the policy objective in using DSAC;<sup>148</sup>

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<sup>146</sup> See for example Ofcom's statement to BT's 2010-11 RFS

<sup>147</sup> E1DD §11.78

<sup>148</sup> E1DD §11.77

- 234.2. the DSAC figures are consistent with the policy objective of providing bounded flexibility for prices;<sup>149</sup>
- 234.3. the calculation of LRICs and the distribution of FCC were carried out in a manner consistent with BT's published methodology (including the use of 'sub-categories');<sup>150</sup> and
- 234.4. the approach to calculating DSACs was not inconsistent with Ofcom's views of how DSACs should be calculated, which was very high level.<sup>151</sup>

### 6.3 Ofcom is mistaken

235. Ofcom's reasoning is flawed and does not justify ignoring the significant issues with the published DSACs BT has discovered since these Disputes began. In the remainder of this Section BT explains why:

- 235.1. the relationship between the published DSACs and FACs is out of line with what would normally be expected;
- 235.2. the published figures are not consistent with the policy objective which has been used by Ofcom to justify using DSAC as a first order test for cost orientation and thus are inappropriate for resolving these Disputes;
- 235.3. the particular way in which the LRIC model has been structured means that it does not work as it is intended to work. It inadvertently attributes too little fixed and common costs to local (".l") cost components (and "sub-components") and too much to core (".c") cost components so that there is a mismatch between Ofcom's views of how DSACs were supposed to be calculated and how they have been calculated; and
- 235.4. the revised methodology proposed by BT (and accepted by Ofcom for the 2010-11 and future RFS) produces results more appropriate to the assessment of cost orientation in line with Ofcom's state purposes.

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<sup>149</sup> E1DD §11.73

<sup>150</sup> E1DD §11.72

<sup>151</sup> E1DD §§11.62 and 11.63

236. First though, BT makes some further general observations:
- 236.1. in both the Ethernet and PPC disputes when assessing cost orientation Ofcom has made adjustments to correct errors in the published numbers, and to be consistent and fair to all parties, Ofcom should correct all errors;
- 236.2. Ofcom says that it will only make corrections where *“the methodology... is obviously inappropriate or if there are mathematical, input or software errors”*<sup>152</sup>; below BT shows that the methodology that underpins the published numbers was obviously inappropriate; and
- 236.3. Ofcom states that one of its reasons for not applying the corrected methodology to the published DSAC figures is that this would *“create poor incentives”*<sup>153</sup> for BT to get its methodology right. This is an ill-considered suggestion; Ofcom ought not to be effectively fining BT considerable sums for having made an error in the published accounts – it has other powers to use for this purpose.

#### 6.4 Duty to use the best available information

237. The law on consistency, transparency and certainty has already been set out above. BT will not therefore rehearse this again. It is contrary to that settled law for Ofcom now to assert that it can ignore BT’s revised figures. It is both inconsistent and contrary to proper certainty for Ofcom effectively to reject the best available evidence when considering (a) whether BT has breached its cost orientation and (b) what is a fair amount to require BT to pay over to the other CPs.
238. Moreover, it is entirely inconsistent with the approach set out by the CAT in the PPC Judgment. At paragraphs 249 and 250 of the PPC Judgment the CAT set out the two stage process involved in assessing compliance, namely:
- 238.1. whether BT has itself demonstrated compliance with the condition; and
- 238.2. if not, then whether Ofcom itself is properly satisfied that BT’s prices are not cost orientated.

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<sup>152</sup> E1DD §11.34

<sup>153</sup> Ditto

239. In carrying out the first stage, it was “for BT to decide how to allocate common costs”<sup>154</sup>. If therefore BT introduces new figures in order to seek to demonstrate its compliance with the cost orientation obligation Ofcom should not reject that material, but allow BT the chance to demonstrate that its charges were, in fact, cost orientated and the evidence to the contrary (i.e. charges in excess of the originally published DSAC figures) was incorrect.
240. But in any event where Ofcom comes to the second stage it, as regulator, cannot itself simply disregard the material and improved allocation methodology introduced by BT in order to demonstrate that it was indeed compliant with Condition HH3. Breaches of SMP ex ante conditions are serious allegations attracting penalties and potentially criminal consequences<sup>155</sup>. Basic fairness to BT and natural justice means that any evidence which is capable of showing that BT may not have been in breach should not be ignored even if there are administrative concerns about effects elsewhere.
241. As was stated in ***Napp Pharmaceuticals v DG of Fair Trading*** [2002] CAT 1 at paragraph 109, and ***Aberdeen Journals v DG of Fair Trading*** [2003] CAT 11 at paragraph 124:
- “...infringements of the Act are serious matters attracting financial penalties. It is the duty of the [Regulator] to satisfy us in each case on the basis of strong and compelling evidence taking account of the seriousness of what is alleged that the infringement is duly proved...”*
242. Further Ofcom’s approach in this dispute is inconsistent with its previous approach. First, in both the Original PPC Final Determination and the present Disputes, Ofcom has conducted its own adjustments in order to obtain what it considers the most appropriate evidence for gauging cost orientation. This was specifically referred to in the PPC Judgment at paragraphs 114 to 118. As the CAT stated at paragraph 116 of the PPC Judgment “*Ofcom considered that the adjustments should not be ignored ‘as they have a material impact on the outcome of our analysis’*” (referring to paragraph 5.82 of Ofcom’s Original PPC Final Determination). If Ofcom conducts such a re-analysis of the figures it is entirely inconsistent for it to ignore BT’s own proposed re-analysis of the figures.
243. Ofcom’s rationale for this otherwise obviously inconsistent approach is that “Ofcom should rely on the published RFS for the purpose of determining these historic disputes” unless “there are obvious errors in BT’s RFS or the methodology used in preparing the RFS was

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<sup>154</sup> See PPC Judgment §249(1)

<sup>155</sup> See e.g. §§ 94 to 103 of the 2003 Act

obviously inappropriate”<sup>156</sup>. As discussed below there are indeed errors in the published DSACs and they are obviously inappropriate for judging compliance with an SMP condition. Accordingly, on Ofcom’s own proposed rationale, the adjustments which BT requested (and produced clear evidence to support) should have been considered.

244. However, in any event, the rationale for such a distinction is flawed. It is clear that there is no unique way that Condition HH3 has to be satisfied. As Ofcom itself has previously stated “...there may be many different ways of attributing these common costs to different services, none of which may be uniquely correct or uniquely reasonable...”<sup>157</sup>. The CAT in the PPC Judgment indicated that “no-one suggested that DSAC was a conclusive indicator that common costs have been appropriately allocated”<sup>158</sup>. If DSAC alone cannot provide a uniquely correct answer, then the position is all the stronger when there is evidence that the DSAC figure itself may need adjustment: a DSAC figure is not uniquely correct simply because it was produced at a particular point in time. To mechanically ignore BT’s evidence because it does not fit the supposed rationale is completely inconsistent with the underlying nature of cost orientation.
245. That is *a fortiori* when Ofcom has itself carried out significant changes to the DSAC figures in any event. Either the DSAC figures originally published in the RFS are conclusive or both Ofcom and BT should be able to re-examine them. Ofcom has plainly adopted the regulatory stance that the published DSAC figures cannot be shut out from presenting its own evidence as to concerns as to the accuracy of them. BT has a real grievance that Ofcom is applying a “double standard”. It rejects the original published DSAC figures when it wants to, but rigidly holds BT to them when BT itself raises genuine concerns. This is the clear paradigm of regulatory inconsistency.
246. Secondly, Ofcom has never previously indicated that it would shut out cogent evidence produced by BT showing that the original DSAC figures were giving misleading indications. To the contrary Ofcom has always considered that, rather than follow the originally published data set, where further data is available Ofcom should use the “more accurate data set” and determine the dispute on “the best available information” (emphasis

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<sup>156</sup> E1DD §11.74

<sup>157</sup> Original PPC Final Determination Annex 11, paragraph A11.6

<sup>158</sup> See PPC Judgment §285



added).<sup>159</sup> BT contends that is the only consistent approach that can be used in the present Disputes.

## 6.5 DSACs and FACs not in a normal relationship

247. A powerful indicator that the LRIC model is not producing the DSACs which are to be expected is that the level of the DSACs relative to FAC is very low. For 2006-07, in the case of the BES and WES rental services, on the basis of Ofcom's adjusted costs, the ratio of DSAC to FAC ranges from 96% to 117%.<sup>160</sup> In particular, the single DSAC below FAC strongly suggests there is an error in the modelling.

248. On this point, Ofcom states that:

*"The existence of DSACs below FAC for certain services (and components) is central to BT's argument that its existing approach to calculating DSACs is wrong."*<sup>161</sup>

and that,

*"We accept that if a DSAC is below FAC then this is unusual. However, rather than being a function of an error or an inappropriate DSAC methodology per se, the observed cases of DSAC being below FAC would seem to be the consequence of the two cost measures [i.e. DSAC and FAC] being calculated on a different basis using two largely separate models"*<sup>162</sup>

249. Ofcom further explains the unusual result by the fact that DSAC and FAC are calculated on different bases, with the former being based on LRIC plus a mark-up for FCCs, whilst FAC uses an Activity-Based Costing methodology.<sup>163</sup> Thus Ofcom adds that,

*"If, for example, BT had derived both FAC and DSAC on the basis of a consistent set of models, we would expect DSACs always to be greater than or equal to FAC."*<sup>164</sup>

250. Here Ofcom is clearly mistaken.

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<sup>159</sup> One illustration of this approach is Ofcom's Final Determination in the Dispute Relating To Sub-Loop Unbundling Charges published 15 July 2011. There, BT contended that, as its prices were well below the DSAC ceilings, this meant BT's prices were cost orientated (see e.g. §4.52). However, Ofcom felt able to ignore the DSAC ceilings and revisit BT's cost allocations so as to exclude several cost items from BT's pricing.

<sup>160</sup> E1DD Table 11.4

<sup>161</sup> E1DD §11.45

<sup>162</sup> E1DD §11.50

<sup>163</sup> E1DD §11.51

<sup>164</sup> E1DD §11.51

251. First, and most importantly, DSAC and FAC are *not* calculated on a wholly “*different basis*” using “*two largely separate models*”. LRIC is actually derived from the FAC model by the application of cost volume relationships (“CVRs”) to FAC. This is set out in the Relationships and Parameters Documentation of the LRIC model. So one must expect the FAC and DSAC estimates to align in a way consistent with the underlying theory regarding the allocation of FCC (i.e. that DLRIC and DSAC set ‘floor’ and ‘ceiling’ boundaries for cost recovery around a central estimate of FAC).
252. Further, even if it was to be accepted that in theory a DSAC calculated on one basis could be lower than the FAC on another, then at the very least such a result would warrant further investigation. Such a result would be very unlikely as DSAC apportions the fixed and common cost of the business over a smaller product set (for example, over just the Core increment of wholesale components) than does FAC (which apportions fixed and common costs over all the services supplied by the company). Such a perverse result should not simply be dismissed on the basis that, “different models will sometimes give different results”.
253. Ofcom has itself used the following schematic setting out the *expected* relationship between DSAC and FAC, showing how DSAC converges towards FAC as the level of aggregation becomes ever wider.<sup>165</sup> (Again, BT accepts that this is not a *necessary* relationship<sup>166</sup> but it is clearly the relationship which is expected and which gives the policy of using DSAC as a first order price ceiling its legitimacy.)

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<sup>165</sup> Determination to resolve disputes between each of Cable & Wireless, THUS, Global Crossing, Verizon, Virgin Media and COLT and BT regarding BT’s charges for partial private circuits, Determinations and Explanatory Statement 14 October 2009.

<sup>166</sup> It might be possible to construct theoretical models in which the expected relationship does not apply but this would be beside the point as the expected relationship should always apply in a business such as telecommunications which is characterised by strong economies of scope.

Figure A11.4: Convergence of DSAC and DLRIC with FAC

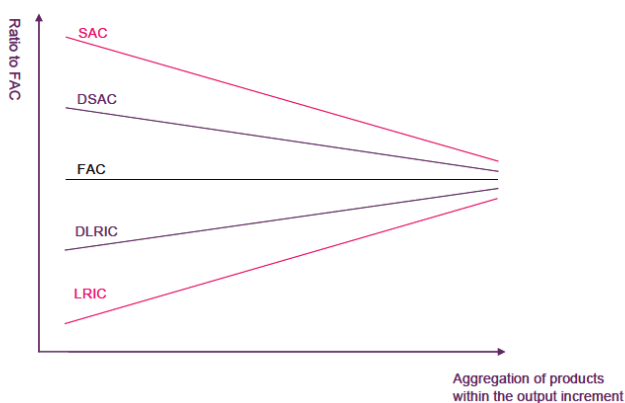


Figure A11.4 from PPC Determination<sup>167</sup>

254. In 2010, Ofcom explained the relationships shown above as follows;

*“As FAC involves allocating all the firm’s common costs across all products, the costs for individual products would normally be above the LRIC and below SAC for the product. Furthermore, we would normally expect FAC to also lie in between the DLRIC and DSAC. However, the extent to which the measures diverge depends upon the size of the output increment being considered.*

*Where the relevant increment of output is the entire output of the firm, then the entire firm’s costs are incremental, including costs that may be common to groups of individual services. As such, the LRIC / DLRIC / FAC / DSAC / SAC measures all converge.*

*Conversely, where the output increment is much smaller than the entire output of the firm, a single product of a multi-product firm for example, the existence of significant common costs will result in a divergence between the cost measures.”<sup>168</sup>*

255. Put differently, if the relationship between DSAC and FAC does not follow the pattern set out in Figure A11.4 above, then this is a matter which warrants investigation especially given the use to which the DSAC data is being put by Ofcom. In particular, if two models were to give very different results, then it would clearly be important both to understand the source of the differences and to reflect them in decisions in order to avoid inconsistent regulation.

<sup>167</sup> This material was taken from Annex 11 of the PPC Final Determination which specifically set out “The Economics of cost orientation” and which was expressly set out so that everyone could be aware of “The concept of DSAC and how it is calculated” – see footnote 6 of the PPC Final Determination. If Ofcom now ignores this previous material it contravenes the requirements of transparency, certainty and consistency which have already been set out above.

<sup>168</sup> Op cit

## 6.6 Published Figures Not Consistent With Policy Objectives

### 6.6.1 The function of DSAC in assessing cost orientation

256. Ofcom is clear that the very function of DSAC is to set a first order price ceiling which is above FAC. For example, in the Draft Determinations, Ofcom itself recognises that *“Imposing FAC as the maximum level of any charge would also risk imposing ‘rate of return’ regulation”*.<sup>169</sup> Using a DSAC which is below FAC clearly imposes regulation which is even more restrictive than rate of return regulation.

257. In his Witness Statement in support of the PPC Determination, Mr Myers stated:

*“Ofcom viewed DSAC as striking a reasonable balance between providing BT with flexibility to price individual services to recover its common costs efficiently and ensuring that this flexibility is sufficiently bounded so as to not allow BT to price in an anti-competitive, exploitative manner or otherwise unreasonable manner.”*<sup>170</sup>

258. Thus, Ofcom’s view is that a price above DSAC is likely to be *“anti-competitive, exploitative or otherwise unreasonable”* but a price between FAC and DSAC provides BT with *“bounded flexibility”*. Clearly there must therefore be a difference between DSAC and FAC if there is to be any *“bounded flexibility”* and if DSAC is less than FAC then this implies that a price in line with (or lower than FAC) could be considered so high as to be *“anti-competitive, exploitative or otherwise unreasonable”*.

259. The existence of a DSAC below FAC brings the issue into sharp focus because the implication of using such a DSAC as a boundary is that the resulting regulatory position is without any economic rationale. It implies that a price which, considered in its own right is deemed to be *“economically meaningful”*, could be below the average cost of supply (FAC) and yet at the same time still be deemed to be excessive. This point is brought into focus where DSAC is below FAC but, the same also applies if DSAC is only slightly above FAC.

### 6.6.2 Bounded flexibility

260. Consistent with Ofcom’s policy, Mr Myers also stated in his PPC witness statement that:

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<sup>169</sup> E1DD \$9.54

<sup>170</sup> CAT Case No. 1146/3/3/09, Witness Statement of Geoffrey Richard Platt Myers, paragraph 35

*“The DSAC approach, therefore, still provides for substantial (but bounded) pricing flexibility. The flexibility on 2Mbit/s trunk pricing was as follows: a. DSACs for 2Mbit/s trunk services were about 75% to 120% higher than FAC and, on average, 85% higher (...). That is, the DSAC approach allowed BT to increase the prices and the recovery of common costs from 2Mbit/s trunk services by a very substantial amount over and above the allowance already included in FAC.”<sup>171</sup>*

261. It cannot then follow that a price below DSAC should be imposed as a price ceiling when this would not allow BT even to recover the same level of common costs included in FAC, or an amount just very marginally above this. Either the DSAC approach to cost orientation allows BT to increase the recovery of common costs by a ‘*very substantial*’ (but still bounded) amount over and above the allowance already included in FAC, or it does not. It is simply not possible to have consistent regulation unless regard is paid to such matters consistently from case to case.
262. It is therefore instructive to compare the WES and BES DSAC price ceilings with those for 2Mbit/s trunk services:
- 262.1. as seen above, the “*bounded flexibility*” for the price of 2Mbit/s trunk services was one which permitted prices which were 85% higher than FAC; this level represents the “reasonable balance” referred to in the earlier quote; and
- 262.2. but the effect of using the unadjusted DSAC figures is to set a price ceiling for the Ethernet services subject to the dispute which is circa 37% higher than FAC (over the period 2006-07 to 2009-10). In 2006-07, the ratio is around 13% higher than FAC and is actually below FAC in the case of BES 100 rental.<sup>172</sup>
263. The difference between the two cases is not a result of a deliberate choice by Ofcom to apply a different policy for Ethernet than for PPCs. Indeed Ofcom has made it clear that it is trying to take the same policy approach. It is rather the case because the original published DSACs were wrongly calculated and are not fit for the purposes of assessing cost orientation.
264. The same result can be seen by considering ROCEs:

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<sup>171</sup> CAT Case No. 1146/3/3/09, Witness Statement of Geoffrey Richard Platt Myers, paragraph 37

<sup>172</sup> In his evidence to the CAT, Mr Myers for Ofcom also mentioned that the “normal” the ratio for DSAC as a percentage of fully allocated costs was 175% “or thereabouts”. PPC Judgment, §300.

- 264.1. in the case of PPCs, the CAT concluded that Ofcom acted correctly in considering the rate of return on capital employed as well as whether the price was above DSAC.<sup>173</sup> On this point, Mr Myers had showed in Table 3 of his witness statement that BT's ROCE on sales of 2 Mbit/s trunk with prices set equal to DSAC was 54% (over the period 2005-06 to 2008-09)<sup>174</sup>; and
- 264.2. in comparison, the effect of using the published DSAC figures for Ethernet is that the boundary level for the average rate of return for the services subject to the dispute would be circa 23%.<sup>175</sup>
265. Such a disparity is a product of the errors in the calculation of DSAC. It has no economic justification and Ofcom is silent on this matter in the Draft Determinations.
266. For Ofcom still to consider that BT's published DSAC figures are appropriate for resolving these Disputes, it needs to explain both why a price ceiling for an Ethernet service (BES 100 rental in 2006-7) is one that earns less than the cost of capital on an FAC basis; and why, when subject to a cross-check on an FAC ROCE basis, the price ceiling for Ethernet services is very much lower than that allowed under the same obligation for Trunk circuits. To do otherwise would be to promote a simple mechanistic regulatory process (that is to say the use of published DSACs as a first order test) above the weighing up of economic considerations which should be central to Ofcom's balancing of duties to resolve disputes appropriately and fairly to all parties.

### 6.6.3 Squaring the circle

267. Ofcom attempts to square the circle regarding its continued use of the original DSACs despite their small margin above FAC by claiming that *"pricing flexibility is provided by the gap between DSAC and DLRIC which is significant for the services in dispute"*.<sup>176</sup> But this is far from satisfactory.
- 267.1. The gap between the two cost measures is irrelevant where the issue is whether or not the disputed prices were so high as to be *"anti-competitive, exploitative or otherwise unreasonable"*.

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<sup>173</sup> E1DD \$9.29.3

<sup>174</sup> CAT Case No. 1146/3/3/09, Witness Statement of Geoffrey Richard Platt Myers, paragraph 37

<sup>175</sup> This is 5 year average, 2006-07 to 2010-11, after repayments and all Ofcom cost adjustments

<sup>176</sup> E1DD \$11.77

- 267.2. The gap between DLRIC and DSAC does not necessarily indicate whether there is any meaningful flexibility in terms of the ability to recover costs; for example DLRIC could be 10% of FAC and if the calculated DSAC is only 90% of FAC then there would only be flexibility as to how much less than the average level of FCCs any service might contribute.
- 267.3. In terms of cost recovery, a price which is too high to be cost orientated must mean, consistent with the wording of Condition HH3.1, that it includes an unreasonably large amount of cost recovery. The minimum for cost recovery under the DLRIC floor (as a ‘first order test’ for an anti-competitive price) is irrelevant to this.
- 267.4. In these Disputes Ofcom is being required to consider prices and not the adequacy or otherwise of the “degree of flexibility between that price and the DLRIC price floor”. The difference between DLRIC and DSAC is simply not informative in terms of the effect of a maximum level of charge under a DSAC restriction.
- 267.5. Ofcom has never previously suggested that consideration of the DSAC: DLRIC ratio, i.e. the extent of the flexibility provided, constitutes a second order test for cost orientation when DSAC is being used as a first order test. It is therefore in BT’s view inappropriate to now replace the “second order tests” used in the PPC Determination with a consideration of the difference between DLRIC and DSAC. This difference has no bearing on whether a price above DSAC is likely to be “*anti-competitive, exploitative or otherwise unreasonable*”.

#### **6.6.4 No flexibility to price on the basis of relative price elasticities**

268. Finally, BT notes Ofcom’s explanation that DSAC provides flexibility to price on the basis of relative demand elasticities.<sup>177</sup> Clearly this flexibility cannot be effective flexibility if the maximum level of charge (DSAC) for the products in question is in line with FAC (as is the case for 2006-07). This implies that no Ethernet service can have more than (or little more) costs than appropriate for a service with an *average* level of price elasticity.
269. Further, Ofcom’s general explanation for DSAC as a regulatory ceiling only has any relevance if BT is allowed to price other services which share the same fixed and common

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<sup>177</sup> E1DD §11.39

costs according to *their* relative price elasticities. This would require that the same form of regulation (DLRIC and DSAC set price boundaries) applies across all services which share the fixed and common costs and hence that the flexibility also applies elsewhere<sup>178</sup>. But this is not the case, as the primary fixed and common cost is duct, an input to LLU and WLR which are subject to separate price controls and hence cannot be priced according to their price elasticities relative to those of Ethernet services. That is, the DLRIC to DSAC flexibility is denied BT elsewhere. Ofcom has therefore proffered a justification for using published DSACs where further restrictions which it has imposed on Openreach deprive BT of the very freedom that is needed for the explanation to be applicable.

## 6.7 Errors in the Calculation of DSAC

270. Ofcom states in the Draft Determinations that it intends to use the published DSACs and not those that result from BT's revised methodology because:

*"BT has not demonstrated that its existing approach to calculating DSACs contains an error or is obviously inappropriate"*.<sup>179</sup>

271. BT considers that the DSACs are *"obviously inappropriate"* for the reasons given above – they mean that the point at which a price is deemed to be excessive under the cost orientation obligation is too low as there is no corroboration that they have been *"anti-competitive, exploitative or otherwise unreasonable"*.

272. BT is nevertheless aware that the DSAC estimates have come from BT's own LRIC model. BT has therefore sought to understand why the LRIC model has produced results which are so at variance with those to be expected (in extremis, where DSAC is below FAC).

273. The methodology supposed to be used to calculate DSACs ought to produce clear, simple and consistent relationships between the different cost measures. Indeed, if the CVR is a straight line (as are the CVRs for both the .c and .l categories) then the LRIC: FAC ratio for any given cost category will be identical for every cost component to which the cost is attributed. Moreover, since FCCs are spread in proportion to LRICs then the LRIC: DSAC ratio for any given cost category will be identical for every component to which the cost is attributed.

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<sup>178</sup> This is for example, quite clear from the explanation of the policy in E1DD §11.39

<sup>179</sup> E1DD §11.74



274. Clearly if costs are spread in this way then the normal relationship one expects whereby LRIC<DLRIC<FAC<DSAC<SAC will be realised (and the calculated DSACs will give the “bounded flexibility” for pricing that is intended by Ofcom’s approach to cost orientation).
275. BT has established that there is a structural issue with the model and which had not been appreciated until the focus on the Ethernet DSACs in these Disputes.
276. As recognised in the Draft Determinations,<sup>180</sup> the problems stem from the use of so-called “split cost categories”, given the shorthand of .c and .l:
- 276.1. .c or “core” covers cost components that lie between an exchange and the core of the network; and
- 276.2. .l or “local” covers cost components that lie between an exchange and customers’ premises.
277. The Core Increment in the LRIC model includes a mixture of .c cost components (for example Ethernet Main Link) and .l cost components (for example Backhaul Extension Services Fibre). The Access Increment in the LRIC model, created specifically for narrowband access, consists entirely of .l cost components.
278. The FAC of the different components is known from the ASPIRE model. In 2008-09, for example, on an FAC basis the Mean Capital Employed (“MCE”) was £[REDACTED]m[C] for the .c duct and £[REDACTED]m[C] for the .l duct. (The annual capital cost is then calculated by multiplying by the cost of capital and allowing for depreciation.)
279. The LRICs of the different components are derived by applying the CVRs (published in the RFS) to the FACs. On this basis, the MCE LRIC for the .c components was £[REDACTED]m[C] and that of the .l components was £[REDACTED]m[C]. Simplifying slightly to aid exposition, the FCC for .c and .l is also known as this is the difference between the FAC and LRIC, so that the MCE FCC for .c is £[REDACTED]m[C] and that for .l is £[REDACTED]m[C], coming to a total FCC of £[REDACTED]m[C].<sup>181</sup>
280. So far, the methodology formerly used in the calculation of LRICs and FCCs was unexceptionable. But the next step was to calculate DSACs by distributing the aggregate FCC for .c and .l in line with the LRICs at the sub-category level. The combination of

<sup>180</sup> E1DD \$11.69

<sup>181</sup> BT has simplified the calculations by leaving out an Increment Specific Fixed Cost (ISFC) which is included in the model. The ISFC is [REDACTED]%[C] of the total FAC and in the LRIC model is attributed to ‘.c’ components in the Core increment. Including the ISFC in the explanation would increase the distortion described here, but not materially.

aggregate FCC and the sub-category LRICs as a basis to apportion the FCC produces the very distorted and illogical results.

281. The issue becomes apparent when considering those categories in just the Core Increment. Here the MCE LRIC for .c was £[REDACTED]m[C] and that for .l was £[REDACTED]m[C]. Using these LRICs to distribute the aggregate FCC means that [REDACTED]%[C] of the total FCC is allocated to .c and only [XX]% [C] to .l.

282. Thus, as set out in the Table below, DSAC for MCE is £[REDACTED]m[C] for .l and is £[REDACTED]m[C] for .c.

**Summary of FAC and LRIC Data for Duct MCE [C]**

Total	.c £m	.l £m	Total £m	Notes
FAC MCE	[REDACTED]	[REDACTED]		From Aspire
LRIC MCE				From LRIC model using CVRs
FCC			[REDACTED]	From LRIC model using CVRs
<b>Core Increment</b>				
LRIC MCE				Aspire FAC inputs and CVRs
FCC			[REDACTED]	Division based on relative LRICs
DSAC MCE				Output

**Table 6.1**

283. These DSACs can be compared to the FACs for the .c and .l cost sub-categories in the Core Increment, as shown below. This shows the distortion that the process has brought about:

283.1. The .l cost sub-categories have a DSAC to FAC ratio of just [REDACTED][C], even though DSAC should always be greater than FAC (in an industry like telecommunications with strong economies of scope); and

283.2. a .c component attracts [REDACTED][C] times as much FCC as a .l component with the same FAC [REDACTED][C].

**DSAC to FAC Ratios for the .l components in the Core Increment [C]**

	.c	.l
DSAC	£[REDACTED]	£[REDACTED]
FAC	£[REDACTED]	£[REDACTED]
Ratio of DSAC to FAC	[REDACTED]	[REDACTED]

**Table 6.2**

284. The core .c components are attracting so much of the FCC that the .l components (and the services which depend on them) do not have enough FCCs for their DSAC to be even as large as their FAC. Under this process, FCCs are being inadvertently allocated away from local services to an extent that has no economic rationale.

285. The end result is particularly perverse as the FCCs primarily relate to the local network due to the fact that it has a large fixed cost (the local duct network is larger than the core and its costs are reduced by less as volumes decline). Thus, the .l local components ought to bearing more of the costs of the local network and .c core components ought to be bearing less.
286. The published DSACs are thus manifestly not appropriate to use in resolving these Disputes.
287. In order to remove the perverse results identified above, it is necessary either to:
- 287.1. distribute the FCC for the .c and .l components separately. This would avoid matching LRICs at the sub-category level with FCC from a more aggregate level; and would distribute the .c FCC across only .c components and .l FCC across only .l components; or
- 287.2. use the aggregated FCC but without using the separate cost drivers (i.e. the CVRs and hence LRICs) for the .c and .l sub-categories.
288. The latter is the appropriate correction to make as it is consistent with the approach for all other cost categories, and also removes complexity and inconsistency from the LRIC model. It also entails less change compared to the published DSACs.
289. Further, the revised DSAC calculations are better aligned with the audited process used to calculate FACs.
290. FAC for duct is calculated within BT's ASPIRE model by attributing the total cost of duct (variable and fixed and common) across components in line with their volumes. These are material costs that are subject to audit to ensure that the process is robust.
291. When the LRIC model was built, it used FAC as a substitute for volumes (in order to save upon having multiple feeds and to ensure absolute consistency with the FAC system). In the LRIC model, the FAC values are converted into relative volumes by dividing the individual FAC values for each component by the total FAC for all components for a given cost category.

292. Under the DSAC attribution, the FCC are attributed to components on the basis of the LRICs<sup>182</sup> (these are expressed as percentages of the total FAC, because what is important is the relative size of the LRICs). But in the original published figures the percentages bore no relation to relative volumes, so that a core network component would have a very different DLRIC value depending upon whether it was in the .c or .l category even when the volume of the component was the same.
293. The method now adopted eliminates the distortion so that the attribution of FCC is consistent between the audited FAC approach and calculation of DLRIC in the revised calculation, and in both cases is now based on volumes. This is clearly a superior process to that used until 2010-11.

## 6.8 Conclusion

294. In this section, BT has therefore demonstrated that the DSACs used by Ofcom to assess cost orientation are not fit for this purpose in that they:

294.1. do not offer BT the appropriate “*bounded flexibility*” to set prices that is supposed to be at the heart of Ofcom’s approach to the first order assessment of cost orientation; and

294.2. are based on a methodology that erroneously allocates the majority of local network costs to .c core components.

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<sup>182</sup> Technically, for a standard (not split) cost category, DLRIC is used but with a straight line CVR, there would be no difference.

## 7. Duration

### 7.1 Introduction

295. In this section BT deals with one further aspect of Ofcom's mechanistic application of DSAC. BT considers Ofcom's decision to find BT in breach of its cost orientation obligation when BT has plainly not been demonstrated to have charged prices in excess of DSAC for the majority of the period (and indeed only has exceeded DSAC for a single year out of potentially five years). Such an application of DSAC is not only inappropriately mechanistic it is also at variance with the approach taken in the original PPC case.

### 7.2 Ofcom's general approach

296. As is clear from paragraph 13.4 of the E1DD, Ofcom proposes to find that BT was in breach of Condition HH3.1 In respect of :-

296.1. WES 10 rental for a single year, namely 2008-09, even though Ofcom had no evidence before it that BT had breached Condition HH3.1 (using DSAC as the compliance measure) in years 2005-06, 2006-07, 2007-08 or 2009-10<sup>183</sup>. In other words, in this example, Ofcom is proposing to find BT in breach of Condition HH3.1 for exceeding DSAC for this single component in a single year.

296.2. BES 1000 connections for a single year, namely 2006-07 even though Ofcom had no evidence before it that BT had breached Condition HH3.1 (using DSAC as the compliance measure) in years 2005-06, 2007-08, 2008-09 or 2009-10. In other words again Ofcom is proposing to find BT in breach of Condition HH3.1 for exceeding DSAC for this single component in a single year.

296.3. BES 100 connections, where the charge was in excess of DSAC for only two years (namely 2006-07 and 2007-08) out of the five years investigated.

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<sup>183</sup> Although it might be suggested that Ofcom was only investigating this single year, and, as Table 13.14 shows, was thus not considering those other years, the very fact that Ofcom "reached no conclusion in relation to 2006/7, 2007/08 and 2009/10 as those years were not in dispute between the parties" (§13.59 of the E1DD was inconsistent with its previous approach from the Original PPC case. In any event, as discussed below in the Ethernet 3 Provision Conclusions Ofcom's investigations show that BT's prices for WES10 Rental were below DSAC for 2006-07, 2007-08 or 2009-10 and 2010-11. In other words Ofcom has only established a price above DSAC once in the six years covering the RFS period 2005-06 to 2010-11: See E3PC Table 6.1

297. Ofcom seeks in Section 9 of the Draft Determination to give reasons why it should reach this result. However, the very fact that Ofcom can consider that this produces a fair and reasonable result demonstrates again the uncertainty and inconsistency in its approach to DSAC. BT will not rehearse again the legal requirements of certainty, transparency and consistency, which have already been addressed in section 2. However, Ofcom's approach to these three components demonstrates a clear breach of these legal obligations<sup>184</sup>. In the rest of section 7.2 BT will first set out the previous approach of Ofcom and the CAT and then address each of the three individual component items set out above and why it would be wholly unfair to find BT in breach of its cost orientation obligations for those years.

### 7.2.1 The previous approach of Ofcom and the CAT

298. Prior to the Draft Determination in the original PPC Dispute, Ofcom had never given any indication that it considered there could be a breach of the cost orientation obligation where BT's prices for a product exceeded DSAC in a single year out of five or six years. Indeed, none of the 1997 and 2001 Guidelines, Condition HH3, or the BCMR and LLMR statements, gave any indication of this policy.

299. In fact the Draft Determination in the original PPC Dispute (published 27 April 2009), far from indicating that Ofcom considered there could be a breach of the cost orientation obligation where BT's prices for a product exceeded DSAC in a single out of five or six years, suggested the direct opposite.

*"5.6 The DSACs of an individual service can fluctuate from year to year, meaning that an unchanged charge that was below DSAC in one year might be above DSAC the year later. In considering the extent to which we can rely on individual years where charges are above DSAC, it is therefore important to bear in mind that BT sets its charges on the basis of the information that is available to it at the time. Given that the DSACs for the year are only known at the end of the year, BT does not know what the appropriate value will be when setting its charges. If charges do not change materially in a year but the DSAC unexpectedly declines, it could be argued that it is unreasonable to consider that this one charge in isolation represents an overcharge.*

*5.7 There may also be accounting treatments of costs that affect the pattern of costs between years. For example, some costs might be expensed in the year in which they are incurred but also yield benefits in other years. In such circumstances revenues might look lower relative to cost in the year in which the costs are expensed and higher in the other years. Considering the comparison between revenues and costs over a period of years reduces the risk of drawing inappropriate conclusions.*

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<sup>184</sup> Ofcom has exhibited a similar approach in the E3PC and the PPC 2 DD.

5.8 For the purposes of resolving the Disputes, it therefore seems reasonable to conclude that overcharging has occurred where charges have been persistently above DSAC for the majority of the period (i.e. for at least three out of four years) or where the variation from the DSAC was caused by an increase in the charges for the service in question. Charges above DSAC for this length of time would indicate that BT has failed to take action to alter its charges in light of them being above DSAC.”

300. In the PPC Final Determination, Ofcom did not suggest in any way that it was changing this approach. To the contrary Ofcom reinforced it<sup>185</sup>:

*“When DSACs of individual service can fluctuate from year to year, meaning that an unchanged charge that was below DSAC in one year might be above DSAC the year later. We believe that this variability is also relevant because, in considering the extent to which we can rely on individual years where charges are above DSAC, it is important to bear in mind that BT sets its charges on the basis of the information that is available to it at the time. Given that DSACs for the year are only known at the end of the year, BT does not know with certainty what the appropriate value will be when setting its charges. If charges do not change materially in a year but the DSAC unexpectedly declines, there may be a case that it is unreasonable to consider that this one charge in isolation represents an overcharge.*

*There may also be accounting treatments of costs that affect the pattern of costs between years. For example, some costs might be expensed in the year in which they are incurred but also yield benefits in other years. In such circumstances revenues might look lower relative to costs in the year in which the costs are expensed and higher in the other years. Considering the comparison between revenues and costs over a period of years increases the robustness of the conclusion.*

*For the purposes of resolving the Disputes, for the reasons set out in greater detail in Section 7, we therefore conclude that overcharging has occurred where charges have been persistently above DSAC for the majority of the period (i.e. for at least three out of the five financial years to which the period of the Disputes relates). Charges above DSAC for this length of time indicate that BT has failed to take action to alter its charges in light of them being above DSAC and would increase the potential for economic harm.*

*Where charges exceeded DSAC in fewer than three financial years, consideration for specific circumstances is warranted. The relevant circumstances may include:*

- (i) The number of the financial years in which charges exceed the DSAC, the magnitude of the excess in each of those years and the trend;*
- (ii) Average charges compared to DSAC across the whole period;*
- (iii) The reasons for the excess and trend, such as:
  - a. Increasing the charge of the services in question;**

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<sup>185</sup> PPC1 FD §§ 5.93 to 5.96

b. Reduction in underlying costs; or

c. Reduction in cost arising from the accounting treatment of costs that does not provide a true picture of the underlying costs in that financial year...”

[emphasis added]

301. Accordingly Ofcom’s previous guidance was that it would not regard BT’s charges as breaching its cost orientation obligation unless BT’s prices were persistently above DSAC (e.g. three out of four years) or there were specific circumstances warranting a finding of a breach. In the latter case Ofcom had specifically stated that it would consider in particular, the number of the financial years in which charges exceed the DSAC, the magnitude of the excess in each of those years and the trend and average charges compared to DSAC across the whole period.
302. This approach, namely that there should only be a finding of breach of the cost orientation obligation where prices were persistently above DSAC or there were other special circumstances, was implicitly endorsed in the PPC Judgment. The CAT made clear that the duration of the excess was an important factor to be taken into account. It was also certainly made clear in the Judgment<sup>186</sup> that Ofcom had to exercise particular care when considering retrospectively whether there had been compliance with the cost orientation provision when BT could only consider the matter on a prospective basis:

*“In particular, Ofcom must have regard to the fact that whereas the regulated company is prospectively seeking to comply with the condition, Ofcom is retrospectively assessing whether there has been compliance. It may be quite difficult for a regulated firm in the position of BT to ensure that its prices meet its cost orientation obligation, even if it has the firmest intentions of doing so. This is for a number of reasons. Ensuring that common costs are allocated in a manner that meets regulatory requirements is not straightforward. The cost accounting – particularly in the case of a product like PPCs in a business with so many products and services like BT – is extremely complex and difficult. What is more, whilst no doubt a regulated firm can keep a month-by-month track of its costs and its prices, at the end of the day the conclusive figures (as published in the regulatory financial statements) will be retrospective ones. Equally, costs can and will fluctuate over time sometimes quickly. Finally the price may be less easily variable. As BT emphasis, it was not possible for BT to vary its prices for PPC services instantly: notice was required.”*

[emphasis added]

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<sup>186</sup> PPC Judgment §§ 298 - 299



303. BT makes four general points.
304. First, no guidance was available to BT in the years prior to 27 April 2009. Accordingly when BT was setting its prices for WES 10 Rentals, BES 100 Connections and BES 1000 Connections for each of the isolated years in respect of which Ofcom now suggests that BT has breached its cost orientation condition, there was no indication that suggested any price in excess for a single year of DSAC could result in a finding of breach of cost orientation. To apply Condition HH3 now in this way is wrong and breaches the law on certainty, transparency and consistency.
305. Second, in any event the guidance given in the Original PPC Determination and the PPC Judgment firmly points against these sets of charges being held in breach of condition HH3.1 for those isolated years.
306. Third, Ofcom in section 9 of the Draft Determinations has itself not followed the approach laid out in its Original PPC decision. By way of one example only, Ofcom expressly stated in its previous guidance that it would consider in particular, the number of the financial years in which charges exceed DSAC, the magnitude of the excess in each of those years and the trend and average charges compared to DSAC across the whole period. However, for WES 10 Rental in the E1DD, Ofcom specifically “reached no conclusion in relation to 2006/07, 2007/08 and 2009/10 as those years were not in dispute between the parties”<sup>187</sup>. As a result, despite the discussion in §§13.55 to 13.57 of the E1DD, it is really impossible to see how there has been any adequate consideration of the trend and the average charges across the whole period.
307. Fourth, BT would add this. Even if Ofcom were to find BT in breach of its cost orientation obligation for isolated years, which would be a serious error, it is simply not fair to require BT now to make repayments under s.190 (2) (d) of the 2003 Act on the basis of information it did not have and could not have accurately forecast at time. This is a matter that could and should be taken into account when considering the level of repayments. To do otherwise would be extremely unfair given the recognition in the CAT’s PPC Judgment of the difficulties which BT faces in seeking prospectively to meet its cost orientation obligations. That is particularly so when looked at isolated years when DSAC was exceeded.

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<sup>187</sup> E1DD §13.59. Indeed, Figure 13.5 Q E1DD does not show WES 10 Rentals per se but the “standard variant WES 10 rentals” (§13.57).

## 7.2.2 WES 10 Rental

308. Regarding this proposed finding of a breach in one year only, Ofcom states that<sup>188</sup>:

*“We have reached no conclusion in relation to 2006/07, 2007/08 and 2009/10 as those years were not in dispute between the Parties. We propose to conclude that BT has overcharged for WES10 rental services only in 2008/09 on the basis that in that year:*

*13.59.1 revenues exceeded DSAC;*

*13.59.2 revenues substantially exceeded FAC;*

*13.59.3 BT’s ROCE substantially exceeded its WACC; and*

*13.59.4 BT breached its maximum cost ceiling as a result of increasing its charges three times.”*

309. BT has already addressed above the failure to reach conclusions on years “2006/07, 2008/08 and 2009/10”. However in any event, matters have now moved on since Ofcom has now provisionally accepted in the Ethernet 3 Provisional Conclusions that, apart from 2008-09 “for all other years of the Relevant Period [in that instance] revenues were below DSAC. We consider that this would support a conclusion of there being no overcharging in any financial years of the Relevant Period other than in 2008/09.”<sup>189</sup>.

310. BT contends that the isolated single year nature of the price above DSAC, is inconsistent with a finding of breach of cost orientation. Both Ofcom’s previous stance in the PPC Dispute and the CAT’s view in the PPC Judgment, point decisively against such a finding, given the difficulty BT faces in prospectively judging the figures.

311. In addition, first, the stepped price increases were planned to address the historic low level of charges against costs. The strategy was developed between December 2006 and January 2007 and aimed to increase the cost of a circuit over a 5 year term by 37%. The rental price increases were explicitly formulated taking both rentals and connections into account.<sup>190</sup>

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<sup>188</sup> E1DD §13.59

<sup>189</sup> E3 PC §6.13

<sup>190</sup> Internal pricing paper OPG 06/07. This sets out that the increases in the rental charge were offset by a decrease in the connection charge of 55%, the value of which Ofcom does not recognise. BT considers that it is mistaken to consider a rental charge without also considering also the connection charge for the reason set out in Section 5.

312. The changes in total aimed to achieve an EBIT margin on each circuit of [15]%(C) - a level which clearly cannot on any basis be regarded as excessive. There was no intention to “overcharge” for this service but to remedy a previous level of “undercharging”.
313. Second, Ofcom’s analysis does not seem to reflect the reduction that BT made to the charge for WES 10 Local Access in June 2007.
314. Third, when the final price increase was notified in early 2008 for implementation in June 2008, the DSAC for 2007-08 against which Ofcom shows the charge for the rental price in E1DD Figure 13.5, was not available. There was no way of knowing that the charge would be above the contemporaneous DSAC. The data which was available shows that the rental was in fact beneath the DSAC (£5,333) known at the time.<sup>191</sup> Ofcom has therefore not taken due account of the fact that BT sets its charges on the basis of the information that is available to it at the time but has taken a wholly retrospective assessment.
315. Fourth, Ofcom only shows that prices exceeded DSAC on the basis of their adjusted DSACs. If the pricing team did not even know the contemporaneous DSAC (i.e. the DSAC for 2008-09, which was only known in August 2009, over four months after the end of the period) it is unreasonable to criticise BT for failing to anticipate the adjustments made by Ofcom many years after the event. The absurdity of criticising BT for failing (for a single year) to anticipate such adjustments is reinforced by the fact that:
- 315.1. BT does not accept that Ofcom’s adjustments are all valid; and
- 315.2. BT contends in any event further adjustments should be made properly to reflect the actual figures.
316. Fifth, there were specific factors influencing pricing which must also be taken into account. BT has already discussed in section 3 the involvement of Ofcom in BT’s pricing in light of the EOI obligations and Ofcom’s broader policy objectives for competition. The overall price increase for WES was consistent with the strategic direction for the portfolio discussed with Ofcom in 2006 which at the time was to:
- 316.1. provide a differential between local access variants of WES/WEES and the local access plus backhaul variants of WES/WEES, in order that CPs were encouraged to

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<sup>191</sup> Page 39 of the contemporaneous 2006-007 RFS:

<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2007/CurrentCostFinancialStatements.pdf>

The 2007-08 RFS would not have been available when the prices were set.

invest in backhaul networks; the WES 10 rental price increases were consistent with this policy objective; and

316.2. rebalance prices such that connections were lower and rentals higher thereby reducing upfront costs and thus encouraging entry and competition in downstream markets.

317. Finally, consistent with Ofcom’s approach in the PPC1 Final Determination, BT shows below the average charge compared to DSAC for the four years shown in Figure 13.5 of THE Draft Determination for which DSACs are available. Both on the basis of Ofcom’s cost adjustments and those adjustments which BT believes are relevant, this shows that, without viewing rentals and connections together, a recognition of the extent and duration of the breach of the first order test indicates that BT has been compliant with the DSAC test as implemented in PPC1 Final Determination.

**WES 10 rental: Extent and Duration of Excess of External Revenue (i.e. charges) against DSAC [C]**

	External revenue £m	DSAC Ofcom adjustments £m	Ratio of Revenue to DSAC, Ofcom adjustments	DSAC BT adjustments £m	Ratio of Revenue to DSAC, BT adjustments
2006-07	2.2	3.4	66%	[■]	■
2007-08	10.2	13.9	73%	■	■
2008-09	29.0	23.2	125%	■	■
2009-10	38.9	40.8	95%	■	■
<b>Total</b>	<b>80.3</b>	<b>81.2</b>	<b>99%</b>	■	■]

**Table 7.1**

318. This shows that there was no overcharging as prices were below DSAC for the majority of the period (i.e. for at least three out of the four financial years to which the period of the Disputes relates). Looked at over the four years, revenues are below DSAC on both Ofcom’s adjustments (charges are 99% of DSACs) and BT’s ([■]%(C)).

### 7.2.3 BES 1000 Connection

319. Ofcom states that:

*“13.52 The primary reason why BT’s charges exceeded DSAC in 2006/07 but not the latter years is that that unit DSACs increased over the period from 2006/07, while charges remained constant or fell.”<sup>192</sup>*

*“13.54 BT has not provided us with specific evidence as to why, despite its 2006/07 revenues for BES1000 connections being above DSAC, these charges were nonetheless cost orientated.”*

320. BT again contends that the isolated single year nature of the price above DSAC, is inconsistent with a finding of breach of cost orientation. There was no persistent transgression over the majority of the period. The previous approach points decisively against such a finding, given the difficulty BT faces in prospectively judging the figures.

321. Further, as in the case of WES 10 rentals, Ofcom positions charges (in this case for 2006-07) against the DSAC for that year, omitting to mention that the DSAC on which it relies for its finding on non-compliance was not known to BT at the time. The 2006-07 DSAC was not published until 21 August 2007 i.e. four months after the end of the period in question.

322. In any event the only published RFS data available was contained in the 2005-06 RFS which was not reporting at a level that would have identified a DSAC for BES 1000 connection<sup>193</sup>. Moreover this must also be seen in the context of BT’s EOI obligations. BT was having to introduce new products, with the specific involvement of Ofcom. Thus for example in 2006 BT was having to introduce a BES 1000 Extended Reach Backhaul Service to meet its EOI obligation<sup>194</sup>. This necessarily made judging the correct level of pricing more problematic when new products were being introduced which could affect the volume and DSAC levels. BT considers it should not be found to be in breach of a first order test for which there was very limited data available at the time to assess compliance in the manner for which it is now being used by Ofcom.

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<sup>193</sup> BT’s RFS contained the following information which suggested that, for the reporting levels required then by Ofcom, BT was cost orientated:

2005-06 RFS	Ceiling	Avg price
Wholesale and LAN Extension Services	13,219.48	8,051.00
Backhaul Extension Services	51,566.38	31,804.00

Page 129, Current Cost Financial Statements for 2006

<http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2006/CurrentCostFinancialStatements2006.pdf>

<sup>194</sup> See e.g. Pricing Paper OPG26/2006, previously supplied to Ofcom.

323. Moreover, BT firmly believes that the DSAC shown by Ofcom for that year has been underestimated. BT repeats that it is wrong to criticise BT for failing (for a single year) to anticipate Ofcom’s adjustments when:

323.1. BT does not accept that Ofcom’s adjustments are all valid; and

323.2. BT contends in any event further adjustments should be made properly to reflect the actual figures.

324. BT has reviewed the cost data and discovered that errors occurred that resulted in the costs attributed to the Ethernet products being significantly understated. As for WES 10 rentals above, the full position is set out in the Table below. Both on the basis of Ofcom’s cost adjustments and those adjustments which BT believes are relevant, this shows that a recognition of the extent and duration of the breach of the first order test indicates that BT has been compliant with the DSAC test as implemented in the PPC1 Final Determination.

**BES 1000 connection: Extent and Duration of Excess of External Revenue (i.e. charges) against DSAC [C]**

	External revenue £m	DSAC Ofcom adjustments £m	Ratio of Revenue to DSAC, Ofcom adjustments	DSAC BT adjustments £m	Ratio of Revenue to DSAC, BT adjustments
2006-07	8.7	3.9	222%	[■]	■
2007-08	7.5	7.7	97%	■	■
2008-09	3.0	6.5	46%	■	■
2009-10	2.4	30.7	8%	■	■
<b>Total</b>	<b>21.6</b>	<b>48.9</b>	<b>44%</b>	■	■]

**Table 7.2**

325. Thus, on any view, when a proper analysis is done of the number of the financial years in which charges exceed the DSAC, the magnitude of the excess in each of those years and the trend and average charges compared to DSAC across the whole period, there is no proper evidence that BT is in breach of its cost orientation obligation. BT’s prices were well below DSAC for the period taken as a whole. Thus BT considers that the information above provides a full justification for Ofcom to recognise that the circumstances of the 2006-07 charges being above the DSAC for that year did not amount to an overcharge.

#### 7.2.4 BES 100 Connection

326. For this charge, Ofcom has found BT to be in breach of its cost orientation obligation in 2006-07 and 2007-08. BT does not believe this proposed finding is justified for the reasons set out below.
327. First, Ofcom compares the charges (in this case for 2006-07 and 2007-08) against the contemporaneous DSAC for those years, but again fails properly to take into account that the DSACs on which it relies for its finding of non-compliance were not known at the time. Thus, for the first of these two years, the 2006-07 DSAC was not published until August 2007 i.e. over four months *after* the period in question. In any event the only published RFS data available was contained in the 2005-06 RFS which was not reporting at a level that would have identified a DSAC for BES 1000 connection.
328. Regarding the second year in question, midway through this year the DSAC for 2006-07 was published. It shows that the charge was above the published DSAC. It is true that BT took no pricing action as a result. However, when in September 2008 price exceeded the published DSAC for a second consecutive year, BT reduced its charge within two months of this becoming apparent.<sup>195</sup> BT considers that, when this is taken into account, along with the magnitude of the excess in each of those years and the trend and average charges compared to DSAC across the whole period, then it is unfair to hold BT in breach of its cost orientation obligation.
329. Further, BT believes that the DSACs for connections shown by Ofcom for 2006-07 and 2007-08 have been underestimated. As explained in Sections 7.42 and 7.43, BT has reviewed the cost data and discovered that errors occurred in mapping components to their end-services. In particular, provisioning costs are excluded from the DSACs for connection costs for BES services 100 in 2006-07 and 2007-08. The full position is therefore set out in the Table below, both on the basis of Ofcom's cost adjustments and those adjustments which BT believes are relevant.

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<sup>195</sup> The implementation of this reduction was then delayed due to complaints from one CP which, as a wholesale competitor, had a commercial interest in BT maintaining the higher charges for longer.

**BES 100 connection: Extent and Duration of Excess of External Revenue (i.e. charges) against DSAC [C]**

	External revenue £m	DSAC Ofcom adjustments £m	Ratio of Revenue to DSAC, Ofcom adjustments	DSAC BT adjustments £m	Ratio of Revenue to DSAC, BT adjustments
2006-07	10.2	2.6	393%	[■]	■
2007-08	4.8	2.8	169%	■	■
2008-09	1.5	2.1	74%	■	■
2009-10	0.0	N/A	N/A	N/A	N/A
<b>Total (3 years)</b>	<b>16.6</b>	<b>7.5</b>	<b>221%</b>	■	■]

**Table 7.3**

Note: BES 100 not reported separately in 2009-10

330. This Table shows that a proper analysis of the extent and duration of prices above DSAC indicates that BT has been compliant with its cost orientation obligation in accordance with the guidance given in the Original PPC Determination. Prices were not persistently above the appropriate DSAC. In particular, when the provisioning costs and other cost adjustments are included in 2006-07 and 2007-08, it is the case that BT was only above DSAC in one year and then only by a small margin.
331. If, contrary to BT's case, Ofcom were to consider that BT had breached its cost orientation obligation by virtue of being over DSAC in two consecutive years, then it would be unfair to find that BT breached its cost orientation obligation in respect of the first of those years. BT had very limited information when judging its prices in 2006-07 (because the 2006-07 DSAC was not published until August 2007 i.e. over four months *after* the period in question and the previous published RFS data available did not contain specific information on BES 100 connection). Any criticism of BT (though BT rejects it) can only relate to its failure properly to adjust its prices after it had the 2006-07 data available in 2007-08.



## 8. “Nascent market” and similar considerations

### 8.1 Introduction

332. In this section, BT considers a number of market features, including but not limited to its nascent, and how Ofcom has again mechanically applied DSAC without looking at the broader picture. In short, Ofcom has given a pre-eminence to DSAC that is simply not warranted in the specific circumstances of this market.

### 8.2 Ofcom’s approach to relevant market factors in the Draft Determinations

333. Ofcom acknowledges in the Draft Determinations that the particular features of the Ethernet market are capable of affecting the assessment of cost orientation. For example, Ofcom says:

- *“Where there is evidence that the specific circumstances faced by a firm in relation to a service gave rise to what might appear to be a breach of a cost orientation obligation, those circumstances should be taken into account in assessing the appropriateness of the charge for that service.”*
- *“[t]he potential for a highly uncertain outcome with a significant ex ante risk that any given product may succeed or fail may be a relevant consideration in deciding whether the pricing flexibility implied by a given cost benchmark is appropriate (as [Ofcom] explain[s] further in paragraph 9.78)”<sup>196</sup>.*
- *“We agree with BT that, in considering the relevance of individual rates of return, we would expect to take into account the specific circumstances that may surround the launch of risky services....”<sup>197</sup>*
- *“In our view a situation in which all of BT’s charges within a specific market were set at DSAC would not necessarily result in a higher rate of return than would be possible in a competitive market....*
- *“... In general, it would be more economically efficient for the firm to put relatively higher mark-ups (i.e. potentially greater than those embodied by a FAC regime) on services where (market) demand is more inelastic...”<sup>198</sup>*

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<sup>196</sup> E1DD §8.55

<sup>197</sup> E1DD §9.78

334. In BT's view these acknowledgements by Ofcom are correct, and Ofcom is required to act in accordance with them and to ensure that relevant market factors are taken into account. This said, in the Draft Determinations Ofcom appears in fact to have taken a very limited approach to establishing what rates of return are appropriate within the meaning of Clause HH 3.1 in relation to the Ethernet market (which is a very different market from the market with which the PPC case was concerned, in particular in being newer, faster changing and characterised by higher levels of risk and uncertainty).

335. To give a few examples of the highly restrictive approach taken in the Draft Determinations, Ofcom:

335.1. emphasises, in the context of its response to *"BT's arguments about the relative immaturity of the AISBO market"*, the fact that *"the wording of the cost orientation obligations imposed on different markets as a result of the 2004 LLMR applies the same requirements regardless of whether the services are in nascent or mature markets"*<sup>199</sup>;

335.2. considers that DSAC is largely to be regarded as an upper bound: for example *"the use of DSAC as a ceiling for individual charges provides BT with an appropriately bounded degree of pricing flexibility over how it recovers common costs across the services that share those common costs"*<sup>200</sup>;

335.3. adopts a process for assessing cost orientation that does not include relevant market factors<sup>201</sup>;

335.4. refuses to date, at least, (albeit that BT acknowledges that Ofcom has invited it to submit evidence on some of these points to Ofcom) to adopt a flexible approach or make any allowances for the following:

335.4.1. the uncertainty created by the fact that the Ethernet market was a new and evolving market, with more or less constant innovation in terms of products and prices resulting in a significant amount of complexity in terms of pricing structures;

335.4.2. the need to reward risk and innovation;

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<sup>198</sup> E1DD §9.55

<sup>199</sup> This comment pays no heed whatsoever to the fact that Condition HH 3.1 refers to what is "appropriate" and "reasonable", and that that must vary from market to market.

<sup>200</sup> E1DD §11.41

<sup>201</sup> E1DD §9.84

335.4.3.the fact that the success or failure of a product (and its lifespan) determines the prospect of recovering the costs invested in relation to that product;

335.4.4.the fact that BT made significant efforts to make Ethernet products available to facilitate LLU and liaised significantly with Ofcom over compliance with EOI undertakings, pricing signals and technological capabilities; and

335.4.5.the fact that (as the volumes of products sold shows) this was a market which grew quickly and significantly, and was not subject to any particular inhibitions on demand.

336. Indeed Ofcom appears generally dismissive<sup>202</sup> of the challenges posed by a nascent and fast changing market.<sup>203</sup> It even appears to be sceptical about the fact that Ethernet was a new and developing market<sup>204</sup>. Instead, Ofcom simply isolates the question of whether there were specific difficulties in establishing the costs for these services<sup>205</sup>. This is one consideration, and section 3.3 sets out the reasons that difficulties were experienced, but it is not the whole picture. BT was acting without the benefit of experience (let alone hindsight) in a rapidly developing field where demand was buoyant, there were a number of individual products, and there were constant technological, commercial and regulatory pressures. These factors are also highly relevant in terms of the standards which BT can be judged by *ex post*.

### 8.3 The relevant market factors that Ofcom should take into account

337. Ofcom ought to take into account (at least) the factors outlined below, each of which constitutes a significant difference from the PPC market, which was an established market. BT ought to be allowed more leeway with Ethernet services than it was with PPCs but (in

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<sup>202</sup> E1DD §8.53-8.56

<sup>203</sup> Similarly, Ofcom appears to propose to take a restrictive approach to the issue of fair bet: see e.g. E1DD §§9.79-9.80 and 13.22.

<sup>204</sup> Ofcom observes that these services had existed before the disputed period as retail services and so were well understood products, E1DD §8.53.1. However, Ofcom had itself recognised in the 2004 LLMR Statement that these wholesale services were ‘nascent’ and that the market was in an early stage of development (and growth since 2004 has proved this to be accurate). The fact that the retail products then in place may have been ‘well understood’ is simply not material set against the changes that took place after the 2004 Leased Lines Market Review and the end of the dispute period, and given the Undertakings driven Chinese walls within BT.

<sup>205</sup> E1DD §8.53.4

large part because the assessment of cost orientation was based on the original incorrect DSACs) the Draft Determinations have the effect of allowing BT less pricing flexibility and a lower ROCE than was the case with PPCs.

338. Ofcom ought to bear in mind that<sup>206</sup>:

338.1. the launch and development of Ethernet services made possible:

338.1.1. the expansion of LLU and the development of a competitive consumer broadband market;

338.1.2. the expansion of backhaul networks, especially by C&W and Virgin Media, using short access circuits for infill on their networks and so stimulating competition in the wholesale market; and

338.1.3. increased supply of data capacity enabling consumer take up of broadband and mobile applications;

338.2. major changes made not just the forecasting, but also the control and management of costs, challenging; indeed Openreach coped throughout the period with the strong and unforeseen growth in demand:

338.2.1. Openreach had to completely overhaul its organisation to meet demand growing much faster than predicted<sup>207</sup>;

338.2.2. new product variants were often partial or whole substitutes for existing products in the portfolio<sup>208</sup>, making forecasting the portfolio mix and the attendant costs of the portfolio difficult; and

338.2.3. Openreach invested in systems to manage the delivery of WES and BES products due to growth in demand;

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<sup>206</sup> BT also relies on the material set out in Section 3.3 above in this regard.

<sup>207</sup> [

<sup>208</sup> [

] [C]

] [C]

- 338.3. BT invested in providing these services, and during this time in providing WES and BES replacement products; technology that would utilise fibre more efficiency and prevent the exhaustion of the existing duct and fibre network. The success of this strategy depended on migration from WES and BES and take up of the new products over time; and
- 338.4. there was uncertainty in whether or not WES and BES products (and particular variants) would succeed or not. Take-up depended on particular customers' needs,. There was also uncertainty about the life-cycle of the products. If investment was to be recouped (both for WES and BES and from EBD and EAD development) it had to be recouped from those products.
339. The cost orientation obligation must be applied in such a way as to permit the various objectives of the regulatory framework to be met. Ofcom's objectives include achieving both allocative efficiency (in other words ensuring that prices reflect costs, and ensure the efficient recovery of fixed costs as set out in §9.55 of the Draft Determination) and dynamic efficiency (in other words encouraging investment and innovation). In effect, margins which are efficient in one market may be harmful in another if in the latter they achieve allocative efficiency but only at the cost of damaging the prospects for dynamic efficiency. Imposing price ceilings close to costs has a negative impact on dynamic efficiency as it reduces incentives to invest where returns are uncertain ex-ante.
340. Dynamic efficiency considerations therefore deserve a far greater weight in the case of Ethernet than more established services by reason of the features of those markets identified above.

#### **8.4 Conclusion**

341. Given the factors explained above, it is inappropriate for Ofcom to expect BT to have set prices that conformed to the DSAC rule during 2006-07.
- 341.1. There was so much uncertainty as to costs and demand that it was very difficult for Openreach to set cost orientated prices. In the event, some charges seem to have exceeded DSAC but this could not have been known at the time when prices were set. In these circumstances much more weight needs to be given to the return to the Ethernet portfolio as a whole.

341.2. Given the risks Openreach was taking and the great efforts it was making to meet demand it would be appropriate for it to be allowed a higher than normal return in the early years.

342. Considering these factors, the just and pragmatic answer would be for Ofcom not to hold BT to be in breach of its cost orientation obligations for 2006-07 at least. Further Ofcom ought to adopt a far more flexible approach to the operation of the DSAC test in later periods as well.

## 9. Overall Assessment

### 9.1 Introduction

343. Above BT has argued that Ofcom has over-estimated the amount that BT might be required to re-pay to resolve these Disputes by *inter alia*:

343.1. not using fully and properly adjusted cost estimates;

343.2. wrongly treating connections and rentals as separate services instead of as different parts of the charge for a single service;

343.3. relying on the original published DSACs which were calculated using an incorrect methodology instead of on the corrected figures provided by BT;

343.4. holding BT to be in breach of the cost orientation obligation when charges exceeded DSAC only for a limited period; and

343.5. not making proper allowance for the fact that Ethernet was a nascent market where costs (and other matters) were subject to an unusually high degree of uncertainty.

344. The rest of this section sets out the impact of correcting for these factors on the amount that BT might be required to re-pay to resolve these Disputes. The factors are treated in the order set out above (and it should be noted that, while the same end answer is produced no matter in what order the calculations are performed, the intermediate totals are sensitive to the order of calculation).

345. It should be noted that tables 9.2, 9.4, 9.6 and 9.8 include totals which may not cast due to rounding.

### 9.2 Ofcom's numbers

346. Table 9.1 shows the DSACs and repayment amounts used by Ofcom in its assessment.

#### DSAC and revenues as used by Ofcom £ m

	06-07	07-08	08-09	09-10	10-11
<b>BES 100 rental</b>					
External revenue	12.1	12.8	13.9	8.3	6.4
External DSAC	6.0	4.5	10.4	8.3	6.6
Difference	6.1	8.2	3.6	0.0	(0.2)
<b>BES 1000 rental</b>					
External revenue	13.1	26.6	28.2	17.2	17.6

External DSAC	2.8	4.5	7.0	7.7	23.9
Difference	10.3	22.0	21.3	9.6	(6.3)
<b>BES 100 connection</b>					
External revenue	10.2	4.8	1.5	0.0	NiD
External DSAC	2.6	2.8	2.1	N/A	NiD
Difference	7.6	2.0	(0.5)	N/A	NiD
<b>BES 1000 connection</b>					
External revenue	8.7	7.5	3.0	2.4	NiD
External DSAC	3.9	7.7	6.5	30.7	NiD
Difference	4.8	(0.2)	(3.5)	(28.3)	NiD
<b>WES 10 rental</b>					
External revenue	2.2	10.2	29.0	38.9	NiD
External DSAC	3.4	13.9	23.2	40.8	NiD
Difference	(1.1)	(3.7)	5.8	(1.9)	NiD
<b>WES 100 rental</b>					
External revenue	4.2	13.5	20.8	27.8	34.5
External DSAC	2.2	7.5	12.6	26.4	70.4
Difference	2.0	6.0	8.2	1.4	(35.9)
<b>WES 1000 rental</b>					
External revenue	1.2	3.1	6.4	8.4	12.8
External DSAC	0.2	0.7	1.4	4.0	11.8
Difference	1.0	2.4	5.1	4.4	0.9
<b>Main link rental</b>					
External revenue	N/A	40.4	64.8	60.9	NiD
External DSAC	N/A	65.6	68.2	132.4	NiD
Difference	N/A	(25.2)	(3.5)	(71.5)	NiD
<b>BES 155 rental</b>					
External revenue	1.1	1.3	0.8	0.1	0.0
External DSAC	0.4	0.2	0.3	0.0	0.0
Difference	0.7	1.1	0.5	0.1	0.0
<b>BES 622 rental</b>					
External revenue	2.9	1.7	1.0	0.0	0.0
External DSAC	0.6	0.2	0.2	0.0	0.0
Difference	2.3	1.5	0.8	0.0	0.0
<b>BES 2500 rental</b>					
External revenue	NiD	NiD	0.1	NiD	NiD
External DSAC	NiD	NiD	0.0	NiD	NiD
Difference	NiD	NiD	0.1	NiD	NiD
<b>BES 10000 rental</b>					
External revenue	NiD	NiD	0.1	NiD	NiD
External DSAC	NiD	NiD	0.0	NiD	NiD
Difference	NiD	NiD	0.1	NiD	NiD
<b>WES 155 rental</b>					
External revenue	0.9	1.4	1.5	1.5	1.4
External DSAC	0.3	0.4	0.5	0.6	1.2
Difference	0.6	0.9	1.1	0.9	0.2
<b>WES 622 rental</b>					
External revenue	0.3	0.4	0.4	0.5	0.5



External DSAC	0.0	0.1	0.1	0.1	0.3
Difference	0.2	0.3	0.3	0.3	0.2
<b>WES 10000 rental</b>					
External revenue	NiD	0.0	0.2	NiD	NiD
External DSAC	NiD	0.0	0.0	NiD	NiD
Difference	NiD	0.0	0.2	NiD	NiD

**Table 9.1**

347. Table 9.2 shows the total adjusted repayment by line.

**Total adjusted repayment by service as used by Ofcom £m**

Repayments £ m	06-07	07-08	08-09	09-10	10-11
BES 100 rental	6.1	8.2	3.6	0.0	N/A
BES 1000 rental	10.3	22.0	21.3	9.6	N/A
BES 100 connection	7.6	2.0	N/A	N/A	NiD
BES 1000 connection	4.8	N/A	N/A	N/A	NiD
WES 10 rental	NiD	NiD	5.8	NiD	NiD
WES 100 rental	2.0	6.0	8.2	1.4	N/A
WES 1000 rental	1.0	2.4	5.1	4.4	0.9
Main link rental	N/A	NiD	NiD	NiD	NiD
BES 155 rental	0.7	1.1	0.5	0.1	0.0
BES 622 rental	2.3	1.5	0.8	0.0	0.0
BES 2500 rental	NiD	NiD	0.1	NiD	NiD
BES 10000 rental	NiD	NiD	0.1	NiD	NiD
WES 155 rental	0.6	0.9	1.1	0.9	0.2
WES 622 rental	0.2	0.3	0.3	0.3	0.2
WES 10000 rental	NiD	0.0	0.2	NiD	NiD
<b>Total repayment by year</b>	<b>35.7</b>	<b>44.5</b>	<b>46.9</b>	<b>16.7</b>	<b>1.4</b>
<b>Total repayment</b>					<b>145.2</b>

**Table 9.2**

### 9.3 Cost Adjustments

348. Tables 9.3 and 9.4 show the DSACs and adjusted repayment after making the cost adjustments and applying the BT proxies described in Section 4.

	06-07	07-08	08-09	09-10	10-11
<b>BES 100 rental</b>					
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>BES 1000 rental</b>					
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>BES 100 connection</b>					
External revenue	■	■	■	■	NiD

External DSAC	█	█	█	N/A	NiD
Difference	█	█	█	N/A	NiD
<b>BES 1000 connection</b>					
External revenue	█	█	█	█	NiD
External DSAC	█	█	█	█	NiD
Difference	█	█	█	█	NiD
<b>WES 10 rental</b>					
External revenue	█	█	█	█	NiD
External DSAC	█	█	█	█	█
Difference	█	█	█	█	NiD
<b>WES 100 rental</b>					
External revenue	█	█	█	█	█
External DSAC	█	█	█	█	█
Difference	█	█	█	█	█
<b>WES 1000 rental</b>					
External revenue	█	█	█	█	█
External DSAC	█	█	█	█	█
Difference	█	█	█	█	█
<b>Main link rental</b>					
External revenue	N/A	█	█	█	NiD
External DSAC	N/A	█	█	█	NiD
Difference	N/A	█	█	█	NiD
<b>BES 155 rental</b>					
External revenue	█	█	█	█	█
External DSAC	█	█	█	█	█
Difference	█	█	█	█	█
<b>BES 622 rental</b>					
External revenue	█	█	█	█	█
External DSAC	█	█	█	█	█
Difference	█	█	█	█	█
<b>BES 2500 rental</b>					
External revenue	NiD	NiD	█	NiD	NiD
External DSAC	NiD	NiD	█	NiD	NiD
Difference	NiD	NiD	█	NiD	NiD
<b>BES 10000 rental</b>					
External revenue	NiD	NiD	█	NiD	NiD
External DSAC	NiD	NiD	█	NiD	NiD
Difference	NiD	NiD	█	NiD	NiD
<b>WES 155 rental</b>					
External revenue	█	█	█	█	█
External DSAC	█	█	█	█	█
Difference	█	█	█	█	█
<b>WES 622 rental</b>					
External revenue	█	█	█	█	█
External DSAC	█	█	█	█	█
Difference	█	█	█	█	█
<b>WES 10000 rental</b>					
External revenue	NiD	█	█	NiD	NiD

External DSAC	NiD	█	█	NiD	NiD
Difference	NiD	█	█	NiD	NiD

**Table 9.3 [C]**

**Total repayments after making the cost adjustments and applying BT proxies as described in Section 4 [C]**

Repayments £ m	06-07	07-08	08-09	09-10	10-11
BES 100 rental	█	█	█	N/A	N/A
BES 1000 rental	█	█	█	█	N/A
BES 100 connection	█	N/A	N/A	N/A	NiD
BES 1000 connection	█	N/A	N/A	N/A	NiD
WES 10 rental	NiD	NiD	█	NiD	NiD
WES 100 rental	█	█	█	█	N/A
WES 1000 rental	█	█	█	█	N/A
Main link rental	N/A	NiD	NiD	NiD	NiD
BES 155 rental	█	█	█	█	█
BES 622 rental	█	█	█	█	█
BES 2500 rental	NiD	NiD	█	NiD	NiD
BES 10000 rental	NiD	NiD	█	NiD	NiD
WES 155 rental	█	█	█	█	█
WES 622 rental	█	█	█	█	█
WES 10000 rental	NiD	█	█	NiD	NiD
<b>Total repayment by year</b>	█	█	█	█	█
<b>Total repayment</b>					█

**Table 9.4**

## 9.4 Connections and Rentals

349. Table 9.5 and 9.6 show the further impact (additional to the BT adjustments and proxies shown in Tables 9.3 and 9.4) of not disaggregating the charge for network access into connections and rentals for the reasons described in Section 4.

**Combined connections and rentals with adjustments to original DSACs [C]**

	06-07	07-08	08-09	09-10	10-11
<b>BES 100</b>					
External revenue	█	█	█	█	N/A
External DSAC	█	█	█	█	N/A
Difference	█	█	█	█	N/A
<b>BES 1000</b>					
External revenue	█	█	█	█	N/A
External DSAC	█	█	█	█	N/A
Difference	█	█	█	█	N/A
<b>WES 10</b>					
External revenue	█	█	█	█	NiD
External DSAC	█	█	█	█	NiD
Difference	█	█	█	█	NiD

<b>WES 100</b>					
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>WES 1000</b>	■	■	■	■	■
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>Main link</b>					
External revenue	N/A	■	■	■	NiD
External DSAC	N/A	■	■	■	NiD
Difference	N/A	■	■	■	NiD
<b>BES 155</b>					
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>BES 622</b>	■	■	■	■	■
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>BES 2500</b>					
External revenue	NiD	NiD	■	NiD	NiD
External DSAC	NiD	NiD	■	NiD	NiD
Difference	NiD	NiD	■	NiD	NiD
<b>BES 10000</b>					
External revenue	NiD	NiD	■	NiD	NiD
External DSAC	NiD	NiD	■	NiD	NiD
Difference	NiD	NiD	■	NiD	NiD
<b>WES 155</b>					
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>WES 622</b>					
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>WES 10000</b>					
External revenue	NiD	■	■	NiD	NiD
External DSAC	NiD	■	■	NiD	NiD
Difference	NiD	■	■	NiD	NiD]

**Table 9.5**

**Combined connections and rentals with adjustments to original DSACs [C]**

Repayments £ m	06-07	07-08	08-09	09-10	10-11
BES 100	█	█	█	█	N/A
BES 1000	█	█	█	N/A	N/A
WES 10	NiD	NiD	N/A	NiD	NiD
WES 100	N/A	█	█	N/A	N/A
WES 1000	N/A	N/A	█	N/A	N/A
Main link	N/A	NiD	NiD	NiD	NiD
BES 155	█	█	█	█	█
BES 622	█	█	█	█	█
BES 2500	NiD	NiD	N/A	NiD	NiD
BES 10000	NiD	NiD	N/A	NiD	NiD
WES 155	█	█	█	█	█
WES 622	█	█	█	█	█
WES 10000	NiD	N/A	N/A	NiD	NiD
<b>Total repayment by year</b>	█	█	█	█	█
<b>Total repayment</b>					█

**Table 9.6**

**9.5 DSAC Errors**

350. Tables 9.7 and 9.8 show the impact of correcting for the DSAC methodology error (discussed in Section 6) in addition to the other alterations proposed.

**Combined connections and rentals with adjustments to revised DSACs [C]**

	06-07	07-08	08-09	09-10	10-11
<b>BES 100</b>					
External revenue	█	█	█	█	N/A
External DSAC	█	█	█	█	N/A
Difference	█	█	█	█	N/A
<b>BES 1000</b>					
External revenue	█	█	█	█	N/A
External DSAC	█	█	█	█	N/A
Difference	█	█	█	█	N/A
<b>WES 10</b>					
External revenue	█	█	█	█	NiD
External DSAC	█	█	█	█	NiD
Difference	█	█	█	█	NiD
<b>WES 100</b>					
External revenue	█	█	█	█	█
External DSAC	█	█	█	█	█
Difference	█	█	█	█	█
<b>WES 1000</b>					
External revenue	█	█	█	█	█
External DSAC	█	█	█	█	█
Difference	█	█	█	█	█
<b>Main link</b>					

External revenue	N/A	■	■	■	NiD
External DSAC	N/A	■	■	■	NiD
Difference	N/A	■	■	■	NiD
<b>BES 155</b>					
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>BES 622</b>					
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>BES 2500</b>					
External revenue	NiD	NiD	■	NiD	NiD
External DSAC	NiD	NiD	■	NiD	NiD
Difference	NiD	NiD	■	NiD	NiD
<b>BES 10000</b>					
External revenue	NiD	NiD	■	NiD	NiD
External DSAC	NiD	NiD	■	NiD	NiD
Difference	NiD	NiD	■	NiD	NiD
<b>WES 155</b>					
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>WES 622</b>					
External revenue	■	■	■	■	■
External DSAC	■	■	■	■	■
Difference	■	■	■	■	■
<b>WES 10000</b>					
External revenue	NiD	■	■	NiD	NiD
External DSAC	NiD	■	■	NiD	NiD
Difference	NiD	■	■	NiD	NiD]

**Table 9.7**

**Combined connections and rentals with adjustments to revised DSACs [C]**

Repayments £ m	06-07	07-08	08-09	09-10	10-11
BES 100	[N/A	■	N/A	N/A	N/A
BES 1000	■	■	■	N/A	N/A
WES 10	NiD	NiD	N/A	NiD	NiD
WES 100	N/A	N/A	N/A	N/A	N/A
WES 1000	N/A	N/A	■	N/A	N/A
Main link	N/A	NiD	■	NiD	NiD
BES 155	■	■	■	■	■
BES 622	■	■	■	■	■
BES 2500	NiD	NiD	N/A	NiD	NiD
BES 10000	NiD	NiD	N/A	NiD	NiD

WES 155	■	■	■	■	■
WES 622	■	■	■	■	■
WES 10000	NiD	N/A	N/A	NiD	NiD
<b>Total repayment by year</b>	■	■	■	■	■
<b>Total repayment</b>					■

**Table 9.8**

## 9.6 Duration

351. The table below shows the amounts which BT would be required to re-pay to resolve the Disputes if Ofcom were to decide that charges had to exceed DSAC for more than one or more than two successive years. The numbers are calculated on both Ofcom's original numbers and on the revised numbers after allowing for the additional cost adjustments, treating connections and rentals as parts of the charge for a single service and adopting the revised DSAC methodology.

£M	Successive Years In Which Charges Exceed DSAC	
	More Than One	More Than Two
Ofcom's Numbers	134.4	124.7
Corrected Numbers	[■]	[■]

**Table 9.9 [C]**

## 9.7 Nascent Market

352. Eliminating the repayments in respect of 2006-07 (at the very least) to recognise the high degree of uncertainty surrounding BT's costs in the early years of the Ethernet market would reduce the total repayment by £35.7m using Ofcom's original numbers and £[■]m[C] using BT's corrected figures.

## 9.8 Concluding Remarks

353. BT stresses that the above calculations are all entirely without prejudice to BT's general points, namely that Ofcom's approach to the Disputes is erroneous and unfair to BT in the context of this particular market. In particular, BT contends that, once the market conditions involved (including the nascent nature of the market, the difficulties that BT encountered judging the take up of products and the other regulatory tensions imposed on BT), the regular involvement of Ofcom with BT's pricing decisions throughout, Ofcom's lack of clear guidance to BT as to what was expected, Ofcom's specific involvement in considering BT's cost orientation in the course of the BCMR and the other factors that have been outlined in the course of this document, once all those factors are taken into account

it is not only wrong to find that BT has breached its cost orientation obligation, but in any event it is totally unfair to order BT to repay monies to the CPs.

354. In giving the specific instances in this section of how the errors in Ofcom's approach impact on the figures, BT is not suggesting that, if Ofcom takes all those points on board and makes all the adjustments in any final determinations, Ofcom will then have correctly resolved the Disputes. BT has identified these specific points to show how the most blatant errors in the Draft Determinations have impacted. BT considers that any order for repayment to the CPs is wrong in the circumstances of these cases. BT firmly hopes that Ofcom will take this view in the final determinations.



## **10. Stand Alone Issues**

### **10.1 Introduction**

355. As already indicated in the various sections above, BT believes that Ofcom is in danger of committing serious errors in its approach because it has gone beyond what the CAT actually decided in its PPC Judgment. BT has referred to these points above and will not repeat them in this section.

356. Over and above that, BT contends that the actual decision contained in the CAT's PPC Judgment was flawed. It is this aspect that this Section addresses. These points have been more fully set out in BT's Amended Notice of Appeal to the CAT of 6 January 2010, BT's 20 May Response and BT's Skeleton Argument and Application for Permission to Appeal to the Court of Appeal (dated 24 June 2011 and referred to as "the Court of Appeal Skeleton"), copies of which Ofcom already obviously possesses. BT will therefore not rehearse all the arguments in detail. However BT does contend that it will be an error on Ofcom's part to ignore these points.

357. BT will consider these points by reference to three specific areas, namely:

357.1. Dispute Resolution;

357.2. Cost Orientation; and

357.3. the Use of the Discretion under s.190 of the 2003 Act.

### **10.2 Dispute Resolution**

358. This was set out in Section 2 of the May 2011 Response and in Ground 1 of the Court of Appeal Skeleton. Essentially it is an error for Ofcom to use the Dispute Resolution procedure to carry out a detailed compliance investigation into an historic dispute because (a) it had no jurisdiction to do so, or alternatively (b) it was a wrong exercise of Ofcom's discretion to employ the Dispute Resolution procedure for this purpose.

359. As to (a), in order to ascertain the meaning and scope of the Dispute Resolution procedure, it is necessary not only to look at the wording of the FD and the AD, but also the context of and the objectives pursued by the FD, the AD and the CRF as a whole. The clear objective pursued by the Dispute Resolution procedure, in contrast to the other statutory enforcement procedures, is to provide a speedy resolution of a current dispute between CPs. When a dispute is referred to the NRA under the Dispute Resolution procedure, the NRA must therefore consider whether or not the relevant dispute is a dispute that can be determined within the short four month limit set by Article 20(1) FD (and s.188 of the 2003 Act). The PPC Determination took not four but fifteen months. In the circumstances, it was (or ought to have been) clear to Ofcom from the outset that if it decided to determine the Disputes under s.185 of the 2003 Act, the four month time limit would be breached. In those circumstances, Ofcom had no jurisdiction to determine the Disputes under s.185 of the 2003 Act. For the same reasons, the CAT erred in holding that Ofcom did have jurisdiction to determine the Disputes using the Dispute Resolution procedure.
360. In relation to (b), (which is effectively an alternative ground based on the assumption that Ofcom *did* have jurisdiction to determine these Disputes under s.186 of the 2003 Act) Ofcom should not have accepted the Disputes under s.185 of the 2003 Act because it was a wrongful exercise of its discretion under s.186 of the 2003 Act to have done so. The Disputes were not disputes that Ofcom could determine within four months and there were alternative means for dealing with the historic compliance disputes (to wit a compliance investigation). The approach adopted by Ofcom and the CAT ignores the obligation on an NRA to be able to resolve a dispute within a period of less than four months, save in exceptional circumstances, and indeed the wider policy objectives in Article 8 FD and the need to resolve disputes in an effective and proportionate manner (Article 8(1) FD and 20(3) FD).

### 10.3 Cost orientation

361. The concerns about the CAT's PPC Judgment are set out in section 4 of the May 2011 Response and Ground of Appeal 2 in the Court of Appeal Skeleton. Essentially, there are three errors in the approach the CAT took in that case. First, the CAT failed to consider, properly or at all, the public law obligations arising from the CRF. Second the CAT failed to consider, properly or at all, the duties under s.3(3) of the 2003 Act, in particular transparency, consistency and proportionality. Third, the CAT failed to take proper or any

account of the 1997 and 2001 Guidelines. Ofcom is in danger of falling into exactly the same errors in the present Ethernet Dispute Determination.

362. The relevant legal principles (not applied by the CAT or indeed Ofcom in the PPC case) are as follows. Article 8 FD provides that, in carrying out the regulatory tasks under the CRF, NRAs must take all reasonable measures which are aimed at achieving the policy objectives set out in that Article. Pursuant to A4(3) of the Treaty on the Functioning of the European Union, *Arcor* [2008] ECR I-2931 and *TRD Appeal* [2008] CAT 12, both Ofcom and the CAT were obliged to construe and apply Condition H3.1 in the light of the scheme and objectives of the CRF.
363. In the PPC Judgment at §321, the CAT considered whether Condition H3 inherently involved first showing economic harm. The CAT specifically rejected this because “*we consider this point confuses the purpose of Condition H3.1 with its legal meaning*” (emphasis added). The CAT erred in its interpretation of H3 because it completely ignored the purpose of the SMP condition, including the scheme and objectives of the CRF, and focussed instead entirely on a “black letter” construction of Condition H3.1. In statutory construction, however, it is clear that a crucial factor in deciding what an obligation means is a consideration of the purpose for imposing that statutory obligation. For example, see *A-G’s Ref (No 5 of 2002)* [2004] UKHL 40 §31.
364. S.3(3) of the 2003 Act imposes an express obligation on Ofcom to act in a manner that is transparent, consistent and proportionate. The requirements of the principle of proportionality were addressed in *Tesco v Competition Commission* [2009] CAT 6 at [135] *et seq* and, in the telecoms sector, *Vodafone v Ofcom* [2008] CAT 22.
365. Accordingly BT contends that in any assessment of BT’s cost orientation condition and in particular whether BT has breached its cost orientation obligation Ofcom must:-
- 365.1. carefully consider the actual effects on competition and investment;
  - 365.2. conduct a proper economic analysis;
  - 365.3. only intervene if it is proportionate; and
  - 365.4. act consistently with its (or its regulatory predecessor’s) statements and approaches previously adopted. In particular BT contends that Ofcom cannot take an approach that is inconsistent with:

- 365.4.1. the guidance that it has previously published as to how it would approach cost orientation (including the 1997 and 2001 Guidelines that it has published which have already been alluded to above in section 3);
- 365.4.2. the requirements it imposed upon BT in terms of both introducing new products (see, for example, section 3 above); and
- 365.4.3. any methodology it previously required BT to adopt.
366. The CAT specifically erred in failing to recognise the following errors in Ofcom’s approach in the PPC case. First, there was failure to act in a consistent and/or transparent way. Ofcom’s decision in the Original PPC Determination to assess Trunk segments in isolation from terminating segments and on a retrospective basis was the opposite of the statement that it made in the 15 December 2005 closure notice. This is a clear breach of the s.3(3) of the 2003 Act duty of consistency. Indeed, in focussing simply upon the individual Trunk segments in isolation the CAT failed to identify what “Network Access” actually meant<sup>209</sup>.
367. Second, the CAT failed properly to consider proportionality and/or the CRF duties: The five steps in a proper proportionality assessment were not considered: (1) legitimate aim: Ofcom failed properly to have regard to the objective of Condition H3.1 (i.e. not to regulate prices per se but rather as a means to ensure that there is effective competition while ensuring efficient investment in infrastructure and no distortion of competition), (2) effectiveness: a competition analysis was required, but not done, (3) targeted, necessary and proportionate: Ofcom identified three ways in which BT’s charges were “likely to have given rise to a number of economic distortions, and therefore to economic harm”, but that assessment, however, (i) was unsupported by the evidence, (ii) failed to have regard to relevant considerations and/or (iii) reached conclusions that were perverse, in the sense of being outside the bounds of reasonable judgement, and (4) and (5) Ofcom’s application of Condition H3.1 produces disproportionate adverse effects in terms of the competitive position of BT and the CPs for retail leased lines, which go beyond what is necessary for

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<sup>209</sup> Thus, for example the CAT (PPC Judgment at §225) ignored that “Network Access” means either interconnection (s.151 (3) (a)) or, if not comprised in interconnection, “any services facilities or arrangements” ((s.151(3)(b)). The CAT’s conclusion was that Network Access had a wide meaning and could mean individualised trunk components. The difficulty with that conclusion however is that it relied upon s. 151(4)(b). However, that only applies where s. 151(3)(b) applies. That includes any services which “are not comprised in interconnection”. In short, Section 151(4) does not apply where the Network Access is “interconnection of public electronic communications networks”. Indeed the point is all the stronger in the present case (and indeed valid regardless of the correctness of the actual decision in the CAT’s PPC Judgment) since there is no question of the focus of the “Network Access” applying across two separate and independent markets as there was in the Original PPC Case.

resolving the Disputes. Further, the CAT disregarded the statutory duty on Ofcom to promote competition and the duty on Ofcom in Article 8 FD to avoid restrictions and distortions of competition.

368. A fundamental error of the CAT was to apply Condition H3.1 solely by reference to its terms and not its underlying purpose and without regard to Ofcom's duties under the CRF and the principle of proportionality. In particular, the CAT's dismissal of the s.3(3) of the 2003 Act duties was a clear error of law. Thus, the CAT's conclusion that DSAC was "the only satisfactory" cost orientation test was wrong and inconsistent with a proper proportionality assessment.
369. Third, in determining how the H3.1 cost orientation condition was to be applied, the CAT erred in treating the 1997 and 2001 Guidelines as in effect irrelevant to the question of determining whether BT's prices were cost orientated. The CAT stated in terms that these were "*of mainly historical interest and tend to be of marginal if any assistance*"<sup>210</sup>. However, the 1997 and 2001 Guidelines were developed in the context of cost orientation imposed by the 1997 Interconnection Directive and cannot be viewed as anything other than giving guidance on how the regulator in the UK would apply cost orientation. Cost orientation is essentially a Community concept.<sup>211</sup> Therefore to construe and consider the cost orientation condition on BT without reference to Guidelines developed in that framework of EU law is the antithesis of a proper approach to cost orientation.
370. Condition H3.1 does *not* lay down *any* test, screening or otherwise. Thus, the CAT erred in concluding that recourse to the 1997 and 2001 Guidelines involves criteria different from those laid down in Condition H3.1. Having stated that it was relying on the 1997 and 2001 Guidelines, Ofcom was obliged to apply the 1997 and 2001 Guidelines, which made clear that an economic harm assessment was the "primary focus" of the investigation. The CAT commented that economic harm was "virtually self-evident". However, if economic harm was virtually self-evident, then there would have been no role for what the 1997 and 2001 Guidelines describe as the "primary focus" of the investigation.

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<sup>210</sup> PPC Judgment §204.

<sup>211</sup> As the Advocate General in *Arcor AG v Bundesrepublik Deutschland* 2008 (Case C-55/06) stated at §32 of his Opinion "*The fact that the concept of cost orientation is a Community concept with its own meaning and scope is confirmed, first of all by two judgments in which the Court was called upon to consider the interpretation of that concept again in the telecommunications sector.*"

371. Ofcom in the DD exhibits that it is in danger of adopting the same errors. Ofcom has not taken any of the above steps in the Draft Determinations and by failing to do so, Ofcom will (in BT's submission) fall into serious error. In particular, (1) Ofcom has acted contrary to its duties of consistency and transparency, (a point in any event made independently of the correctness of the actual PPC Judgment for all the reasons set out earlier in this document), (2) Ofcom has failed properly to consider the five steps in a proper proportionality assessment, (3) Ofcom has failed to apply the 1997 and 2001 Guidelines properly, and (4) Ofcom has not properly investigated the market effects, including what market harm there was in reality. Each of these failures is a serious one and Ofcom must, in fact, comply with all of these duties and perform all of these steps.

#### **10.4 The use of the Discretion under s 190 (2) (d) of the 2003 Act**

372. This was set out in Section 5 of the May 2011 Response and in Ground 3 of the Court of Appeal Skeleton. Essentially, it is an error for Ofcom to use its powers under s.190(2)(d) to order a mechanistic repayment of any price charges above the specific DSAC figure for any year because (a) it is unlawful as a matter of EU and English public law and (b) contrary to well-established English compensatory and/or restitutionary principles.

373. In relation to (a), the CRF empowers NRAs to resolve disputes and where necessary to "impose a solution on the parties" (Recital 32 FD). But it is silent as to the precise means of enforcement. In the absence of specific EU provisions, the cause of action and the substantive and procedural conditions for relief are left to domestic law subject to the limits imposed by EU law. Ofcom's Dispute Resolution powers (under s.190 of the 2003 Act) have to be construed in the light of the objectives of the CRF. Any direction for BT to make payment must satisfy the policy objectives laid down in Article 8(2) FD as well as the proportionality and consistency/transparency requirements in s.3(3) of the 2003 Act. Before deciding whether to order payment of the sums under s.190(2)(d), Ofcom should have (but did not) carried out the five-step proportionality assessment, as above. The CAT in the PPC Judgment failed to consider whether the payments ordered complied with these EU and public law duties.

374. In relation to (b), the basis of the payment regime in s.190(2)(d) of the 2003 Act is either compensatory or restitutionary (it is patently not a punitive regime). To determine the basis of the s.190(2)(d) of the 2003 Act payment regime as a matter of English law, it is

necessary to look at it in the context of the 2003 Act as a whole and to adopt a principled approach which reflects general principles inherent in other areas of the law (*4Eng Ltd v Harper* [2009] EWHC 2633 (Ch)). As a civil regime, and adopting a principled approach, the s.190(2)(d) regime must be a compensatory regime or, alternatively a restitutionary one.

375. The payment regime under s.190(2)(d) of the 2003 Act appears compensatory in view of the parallel enforcement regime for breach of statutory duty under s.104(2)(a) of the 2003 Act, which is compensatory in nature. If the s.190(2)(d) of the 2003 Act payment regime is compensatory in nature, the payments being proposed by Ofcom in the Draft Determinations are plainly wrong because there has been no finding of any loss suffered by the CPs.
376. If the s.190(2)(d) of the 2003 Act payment regime is not compensatory, then it is restitutionary. Applying restitutionary principles, the Disputing CPs are also not entitled to the sums that BT has been ordered to pay. A true restitutionary approach is based on principles designed to ensure that neither claimant nor defendant is unjustly enriched at the expense of the other. "Counter-restitution" must be taken into account so that restitution for the CPs of BT's unjust enrichment does not, in turn, result in the Disputing CPs' unjust enrichment at the expense of BT. See, for example, *Spence v Crawford* [1939] 3 All E.R. 271 and *Halpern v Halpern (Nos 1 and 2)* [2007] EWCA Civ 291, [2008] QB 195.
377. In the Original PPC case Ofcom fell into error even if the payment regime is restitutionary. Applying a counter-restitution analysis, the Disputing CPs benefitted from the PPC contracts and were not overcharged in relation to PPCs as a whole. BT's "circuit analysis" and "ROCE analysis" make this clear. In the circumstances, the payment directions, by not taking into account the benefits received by the CPs from BT, are an unjust, unmerited and inappropriate enrichment.
378. The same is true in this instance because Ofcom has failed to carry out any counter-restitution analysis at all. By way of example only, Ofcom has entirely failed to take into account (1) the kind of material set out in section 4 above in relation to connections and rentals and/or (2) the evidence relevant to the duration issue set out at section 7 above.
379. This important material will not be repeated here. However, by way of brief illustration in relation to (1), Ofcom has failed to take into account the fact that connections and rentals are not separate services with separate charges, but rather are different aspects of the charge for a single service. BT contends (see section 4 above) that there should be no

disaggregation between connections and rentals. But, even if that were not to be the case, before considering any repayment under section 190(2)(d), the benefits to CPs of one should be balanced against the detriments of the other so there is no unjust enrichment at the expense of BT. Regard should be had by Ofcom to all of the material set out above in relation to connections and rentals when considering (as it should) a counter-restitution analysis.

380. By way of brief illustration in relation to (2), Ofcom has entirely failed to apply a counter-restitution analysis to the “duration” points set out above, in particular that the normal contracts would last three or five years. If there was (alleged) overcharging in one year, that must be counter-balanced against the rest of the contractual years, otherwise there would be clear and unfair unjust enrichment in favour of the relevant CPs as against BT. Again, BT will not repeat here the detail set out above in relation to “duration”, but Ofcom’s failure to consider this material so far is plainly an error. Ofcom must conduct a full and proper counter-restitution analysis in this case, including (but not limited to) addressing points (1) and (2) above.
381. If Ofcom fails to do so, the payment directions ultimately made by Ofcom (i.e. in all of E1DD, E2PD and E3PC) will, by not taking into account the benefits received by the CPs from BT, be unjust, unmerited and inappropriate enrichments.

**British Telecommunications plc**

**20 April 2012**



## Annex A

“Mark Shurmer  
Openreach  
PP: 3.63  
123 Judd Street  
London  
WC1H 9NP

6 December 2010

Dear Mark,

### **WLA Consultation**

Thank you for your letter of December 3<sup>rd</sup> requesting further clarity on the interpretation of BT’s cost orientation obligations in the WLA market.

Following the WLA market review, BT has an obligation to secure, and to be able to demonstrate to the satisfaction of Ofcom, that each and every charge for network access falling within the WLA market, with the exception of the VULA and MPF rental charges, is reasonably derived from the costs of provision, based on a LRIC+ approach to costing.

Under the terms of the EC Access Directive, the burden is on BT to ensure compliance with this obligation. In doing so, BT should have regard to the guidance on cost orientation set out in Oftel’s December 2001 network charge control guidelines, and to the way in which Ofcom has applied this guidance in the context of PPCs. You suggest that Ofcom’s position on cost orientation seems to have evolved during the PPC hearing and that it is not clear how the basis of charges obligation should be applied to WLA services. We do not believe that to be the case.

Our policy is to review guidelines periodically and it is our intention to review and consult on the guidelines on cost orientation in the first half of 2011, resources permitting. This timing is contingent on developments at European level, as we understand that the European Commission may itself be planning to issue some guidelines on cost orientation. If that is the case, it may affect the timing of our consultation. In the meantime, the existing guidelines apply.

On the specific points you raise in relation to WLA, our response, consistent with the 2011 guidance and its application in the PC case is as follows:

- It is not our position that WLA charges outside the DSAC/DLRIC range are necessarily in breach of the cost orientation requirement, though this is a very significant consideration in our assessment of overcharging. As set out in the 2001

guidelines and the PPC determination, we see charges being within the range as an important first order test, but it is not determinative on its own. Where WLA charges fall outside this range, other considerations would also be taken into account when assessing compliance. These secondary factors include the extent to which and the period over which charges exceed DSAC, whether the charges could potentially cause economic harm, rates of return and any other evidence that BT submits to justify why its charges are cost orientated.

You mentioned your concern that the wording of paragraphs 5.58 and 5.79 of the WLA statement appears to suggest that the cost orientation obligation carries with it an automatic requirement for BT to adjust its prices, wherever they are outside the DSAC/DLRIC range. I should like to clarify that, consistent with the cost orientation guidance and the use of DSAC/DLIC as a first order test, there is no such automatic requirement. We intend to publish a short note on our website in the near future, clarifying this point.

- In our view it is clear from the wording of the SMP condition itself that the cost orientation obligation applies to each and every WLA charge. It is not therefore appropriate to talk in terms of the requirement being applied to an aggregation of services. However, as noted above, the first order test is not determinative. Other factors are to be taken into account before concluding on whether a particular charge is or is not cost orientated and the factors which are relevant to this “second order test” will depend on the case in question. As an example, in our determination of the PPC dispute and also in the appeal documents, we have set out the “second order” factors that we consider relevant to PPC trunk charges. Many of these factors are likely to apply more generally as well, including to WLA.

With regard to the question of connections and rentals, we recognised in the PPC appeal that it made sense to look at services together if they are bought in fixed proportions. Connections and rentals have an element of fixed proportions through minimum contract periods, although there is also a variable element as contract periods vary. This is one of the issues we would be likely to consider in an assessment of cost orientated charges for those WLA services which are subject to the cost orientation requirement.

You also refer to the potential for taking a lifecycle approach to pricing new investment. This seems to us to be a separate issue from the each and every charge question. However, we recognise that there may be a connection, in the sense that the accounting data used to generate estimates of DSAC/DLRIC may be subject to distortions. In the case of new investments, for example, if initial asset utilisation is well below the level in the longer term, accounting data may not provide an appropriate basis for assessing compliance with the cost orientation requirement. Again, this is one of the factors that could be taken into account as part of the second order evaluation. While this is our initial view of this matter, it may be useful to have further dialogue with you on the best approach to use when costing

new WLA services, in the context of your plans for ensuring compliance with cost orientation requirements in the future.

- More generally, we would note that the DSAC/DLRIC range is typically wide, and will therefore provide a considerable amount of pricing flexibility. Taking all these factors into consideration, we do not consider that the cost orientation obligations imposed on BT in the WLA market review will unduly constrain BT's pricing freedom.

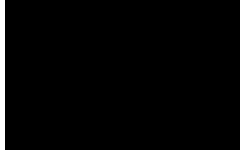
I trust that this helps to clarify our position on the issues you have raised. If you would like to discuss these matters further, please do not hesitate to contact me.

Yours sincerely

Gareth Davies, Competition Policy Director"

## Annex B

[c]



## Table of Confidential Redactions [C]

No:	Redaction:	Rationale:
1	Table EX 1, p10	BT information which has not been published and the disclosure of which would likely cause BT harm
2	Table EX 2, p11	Ditto
3	Table 3.1, p42	Ditto
4	Figure 3.1, p43	Ditto
5	Figure 3.2, p43	Ditto
6	Figure 3.3, p44	Ditto
7	§73	Record of meeting, possibly "in-confidence", between BT and Ofcom
8	§74	Ditto
9	§75	Ditto
10	Footnote 78	BT information which has not been published and the disclosure of which would likely cause BT harm
11	§84	Extract, possibly "in-confidence", from a letter between BT and Ofcom
12	Table 4.1, p63	BT information which has not been published and the disclosure of which would likely cause BT harm
13	Table 4.2, p65	Ditto
14	Table 4.3, p67	Ditto
15	Table 4.4, p68	Ditto
16	§146	Ditto
17	Table 4.5, p68	Ditto
18	Table 4.6, p69	Ditto
19	Table 4.7, p69	Ditto
20	§149	Ditto
21	§151	Ditto
22	Table 4.8, p70	Ditto
23	Table 4.9, p70	Ditto
24	Table 4.10, p71	Ditto
25	Table 4.11, p72	Ditto
26	§159	Ditto
27	Table 4.12	Ditto
28	Table 4.13	Ditto
29	§178	CP information or information about a CP the disclosure of which may harm that CP or provide an advantage to other CPs
30	§181	Ditto
31	Figure 1, p79	Ditto
32	Figure 2, p79	Ditto
33	§278	BT information which has not been published and the disclosure of which would likely cause BT harm
34	§279	Ditto
35	Footnote 181	Ditto
36	§281	Ditto
37	§282	Ditto
38	Table 6.2, p106	Ditto
39	§283	Ditto
40	Table 6.2	Ditto

41	§312	Ditto
42	Table 7.1, p116	Ditto
43	§318	Ditto
44	Table 7.2, p118	Ditto
45	Table 7.3, p120	Ditto
46	Footnote 207	Ditto
47	Footnote 208	Ditto
48	Table 9.3, pp129-131	Ditto
49	Table 9.4, p131	Ditto
50	Table 9.5, pp131, 132	Ditto
51	Table 9.6, p133	Ditto
52	Table 9.7, pp133, 134	Ditto
53	Table 9.8, pp134, 135	Ditto
54	Table 9.9, p135	Ditto
55	§352	Ditto
56	Annex 2	CP information or information about a CP the disclosure of which may harm that CP or provide an advantage to other CPs