Ofcom Consultation – Leased Lines Charge Control

A new charge control framework for wholesale traditional interface and alternative interface products and services

Sky's response

1. Summary

1.1. Openreach's Ethernet prices have been inefficiently high for too long. Cost orientation has failed as a remedy and, as a result, businesses and consumers have been exposed to higher retail pricing, increased contention, lower broadband speeds, traffic shaping, smaller LLU footprints and less service innovation. Openreach's latest price cuts should have been introduced much earlier and, for some Ethernet products, may not go far enough.

1.2. Delays to the introduction of the AISBO[1] charge control are directly attributable to BT's failure to publish its regulatory accounts accurately and on time. Therefore, Ofcom should oblige Openreach to backdate its pricing reductions to 1ST October 2008 and move all Ethernet charges below their LRIC ceilings immediately. Alternatively, Ofcom should demonstrate that the AISBO charge control has been re-calibrated to reflect that lower prices should have been introduced sooner. Furthermore, in light of the dramatic deterioration in the economic climate, Ofcom needs to revisit its analysis to ensure that the charge controls are based on the latest market data.

1.3. Sky is affected by high wholesale prices because it is both an LLU operator and, through Easynet, a supplier of business connectivity products. Wholesale AISBO and, to a lesser extent, wholesale TISBO are crucially important inputs for the retail products that Sky and Easynet offer to their customers.

1.4. Therefore, this response focuses predominantly on AISBO issues, although certain comments are equally applicable to TISBO markets.

The need for charge controls because cost orientation proved an insufficient constraint

1.5. In the Business Connectivity Market Review ("BCMR"), Ofcom justified the introduction of a charge control for Openreach wholesale AISBO on the basis that:

> "*BT has been subject to a cost orientation requirement for these services* [wholesale Ethernet services] *since the 2003/4 Review. We considered however that, given the relatively high returns, cost orientation alone might not be enough in the future."* [2]

Sky agrees that, in these circumstances, it is appropriate and justified to impose an AISBO charge control remedy.

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[1] Alternative Interface Symmetric Broadband Origination i.e. Ethernet

[2] Statement, 8th December 2008, Paragraph 8.254

Openreach's customers should be reimbursed for the late introduction of lower Ethernet charges due to BT's failure to publish its regulatory accounts on time

1.5 Ofcom states that Openreach's recent Ethernet price reductions have obviated the need for the imposition of one-off price reductions prior to the start of the charge control period. As the introduction of the charge control was delayed due to BT's failure to comply with its obligations to publish accurate and timely regulatory accounts, it is appropriate that these reductions be backdated to October 2008[3] either directly or via an adjustment in the charge control.

Technologically neutral model could allow too much scope for over-recovery

1.6 Sky recognises the theoretical benefits of a technologically neutral approach to the AISBO charge control whereby Openreach is rewarded for encouraging the adoption by communications providers of efficient, lower priced 21CN-based Ethernet services. However, 21CN Ethernet offers significant cost reductions and is not a risky development. Should Ofcom set base year starting costs for the hypothetical network[4] too high or the "glide path" for the control is too shallow, then BT's windfall gains will be inefficiently high.

The world has changed since Ofcom's initial analysis

1.7 In calculating base year starting costs and the subsequent glide path, it is appropriate and necessary for Ofcom to take account of the marked deterioration in the macro-economic climate since it started its analysis. Specifically, Ofcom needs to revisit its assumptions regarding asset prices, wage costs and energy prices.

Ofcom's range of efficiency improvements is insufficiently ambitious

1.8 In setting efficiency levels for the AISBO control, Ofcom has chosen merely to apply the level set in the Openreach Financial Framework Review despite material differences between the proportion of controllable costs in copper access and fibre-based Ethernet services. This is not objectively justifiable and, even if it were, the efficiency levels proposed by Ofcom are too conservative.

Other points of detail

1.9 In this response we also address other material considerations:

- Problems with the reliability of BT's Regulatory Financial Statements ("RFS")
- BT's incentives
- Inconsistency between Ofcom's NGA policy and BT's argument that it should be allowed a higher WACC on certain AISBO services
- Cost recovery of Service Level Guarantee ("SLG") payments
- Pension costs

[3] Ofcom's original target start date for the AISBO charge control
[4] Effectively based on current generation Ethernet portfolio costs

1.10. Whilst there are continuing concerns over the accuracy of BT's RFS, they do indicate that Openreach Ethernet prices have not been cost-oriented. In fact, over the last few years prices have remained at persistently high levels. Recent innovations by Openreach such as the latest price reductions, introduction of term discounts and new products like Connectivity Services go some way to alleviate these issues. However, we remain concerned that the pricing of Ethernet services by Openreach, particularly at the higher bandwidths, is still above their respective Long Run Incremental Cost ("LRIC") ceilings.

2. The need for charge controls because cost orientation proved an insufficient constraint

2.1. As both an LLU operator and supplier of business connectivity products, Sky is heavily reliant on well-functioning wholesale leased line markets. Whilst retaining some interest in traditional, SDH-based leased line services such as Partial Private Circuits (PPCs), Sky is predominantly a purchaser of wholesale Ethernet services for access and backhaul. This market, known as the wholesale Alternative Interface Symmetric Broadband Origination ("AISBO") market, has been growing steadily over the last few years with wholesale Ethernet services forming a crucial input to our consumer broadband and business communications products.

2.2. For some time now, Sky has been concerned that Openreach's wholesale Ethernet prices have not been cost oriented. Whilst the most of Openreach's Ethernet portfolio has been exhibiting significantly high pricing, Sky has felt the impact most keenly at the higher bandwidths.

2.3. We outlined our concerns in our response to the BCMR consultation last year by showing the high ratio of prices to fully allocated costs (FAC) in BT's RFS 06/07. Since then, BT has re-stated these accounts within the published accounts for 07/08[5]. The latest sets of accounts show that most Ethernet prices exceed LRIC ceilings. Indeed, aggregate returns across the portfolio significantly exceed Ofcom's stated cost of capital for these BT services. In Ofcom's BCMR statement (December 2008), it is stated that:

> *"Since the earlier consultations, BT has issued its 2007/08 regulatory accounts. These restate BT's reported revenues for 2006/07 for the AISBO markets, significantly raising them. For all bandwidths, BT's ROCE on AISBOs was 31 per cent in 2007/08. The restated ROCE for 2006/07 was 27 per cent, compared to the figure reported in the January 2008 consultation of 20 per cent".*[6]

In 2005, Ofcom estimated a relevant cost of capital of 11.4% for BT's AISBO services.

2.4. Such a higher cost base risks disadvantaging end users through higher retail pricing, increased contention, lower broadband speeds, traffic shaping, smaller LLU footprints and less service innovation. It is also important to note that BT does not internally consume Openreach LLU backhaul (BES) in order to supply its own broadband

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[5] Section 3.10 AISBO http://www.btplc.com/Thegroup/RegulatoryandPublicaffairs/Financialstatements/2008/Currentcostfinancialstatements2008.pdf

[6] Paragraph 7.135

services over IPStream, resulting in potential for discrimination between LLU operators and BT.

2.5. In theory, this shouldn't happen. The supply of wholesale Ethernet services by BT has been subject to a cost orientation obligation[7] at least since the AISBO market was last reviewed in 2004.[8] However, as cited above, there is strong evidence that BT's historic wholesale Ethernet pricing would fail a first order test of cost orientation, namely, prices being within LRIC floors and ceilings. Specifically, average prices appear to have exceeded LRIC ceilings.

2.6. Whilst we recognise that questions remain as to the accuracy of BT's unaudited LRIC floors and ceilings within the regulatory accounts, there is further evidence that indicates that prices have not been cost oriented. These include the high ratio of average prices to audited fully allocated costs (FAC) for most AISBO services, the steep bandwidth-related pricing gradient employed by Openreach (which cannot be adequately explained by small variances in equipment costs) and the scale of Openreach's recent Ethernet price reductions.

2.7. Given the evidence above, it is appropriate for Ofcom to impose a charge control on Openreach's wholesale AISBO services up to and including 1 Gb/s. In fact, the introduction of this remedy and a further requirement for all prices to be between LRIC floors and ceilings implies that, not only have historical prices been too high, but also that such high pricing has been detrimental to the wholesale AISBO market and, by extension, to end users.

2.8. Furthermore, it is appropriate to introduce Wholesale Ethernet Services ("WES") and Backhaul Ethernet Services ("BES") sub caps as these would reduce the scope for Openreach returns from providing LLU backhaul services, via BES, to effectively "cross-subsidise" business connectivity Ethernet (particularly, lower bandwidth WES) and vice versa. It is apparent that cost orientation remedies by themselves have not been effective and that, without the sub caps, the risk of "cross subsidy" would remain.

2.9. Similarly, connection and rental sub caps should reduce the opportunity for Openreach to rebalance rental and connection charges to take advantage of changes in demand over a product's lifecycle.

3. Openreach's customers should be reimbursed for the late introduction of lower Ethernet charges due to BT's failure to publish its regulatory accounts on time

3.1 Notwithstanding the fact that historical Openreach Ethernet prices should have been lower in order to achieve compliance with BT's cost orientation obligation for AISBO services, we also consider that Openreach's latest Ethernet price reductions should have been implemented sooner than 1st February 2009 i.e. 1st October 2008 which was the originally intended start date for the AISBO charge control.

The charge control was originally planned to start on 1st October 2008

[7] We also note that BT is subject to a direction under the cost orientation condition covering pricing matters relating to Ethernet-based LLU backhaul
[8] Leased Line Market Review ("LLMR") 2004

3.2 In the BCMR – first consultation – Ofcom outlined its plans for the introduction of an AISBO charge control including the target start date and a consideration of whether there was a need for one-off price reductions:

> *"We are proposing to price control alternative interface services in future. Work is underway to set charge controls from 1 October 2008. We are actively considering whether there should be a one-off adjustment to individual charges at the outset. With this aim in mind we are seeking to refine our understanding of the underlying costs of these services. We plan to consult on our pricing proposals for services within the scope of the charge control, including those for alternative interface services, in the Spring 2008."* [9]

The delay was BT's fault and so it committed to backdating the outcome of the LLCC

3.3 On the 28th July 2008, BT Wholesale announced delays in the publication of BT's RFS for 2007/08,[10] where it stated that:

> *"Should this timetable impact the setting of any price controls for partial private circuits and wholesale Ethernet products, BT accepts that such controls would have effect from 1 October, retrospectively."*

3.4 Also, on the 28th July 2008, Openreach issued a General Briefing (GEN 070/08):[11]

> *"Due to BT's regulatory accounts being restated and published in late October 2008, Ofcom has decided to delay the Leased Lines Charge Control and the Openreach Financial Framework Charge Control documents.*
>
> *In order to minimise impact on our customers, Openreach will implement the outcome of the Leased Lines Charge Control, where applicable, as if it had been available from 1 October 2008 (Ofcom's original timescales). Equally, we expect the Financial Framework outcome to enable price changes to be implemented by 1st April 2009."*

3.5 As previously mentioned, BT's delayed publication of its RFS 07/08 also included re-statements of its RFS 06/07 with respect to both AISBO and TISBO services and, as Ofcom intended to use RFS 06/07 AISBO data as a basis for setting AISBO charge controls, the delays in the imposition of the control are directly attributable to BT's own errors.

Late publication of the RFS appears to be a breach of BT's regulatory obligations

3.6 Under SMP service condition OA6(b),[12] BT is obliged to:

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[9] Paragraph A12.5, page 452

[10] http://www.btwholesale.com/pages/static/News_and_Briefings/editorial_Publication_of_the_200708_Regulatory_Financial_Statements.html

[11] http://www.openreach.co.uk/orpg/news/generalbriefings/gen07008.do

[12] Page 49, "The regulatory financial reporting obligations on BT and Kingston Communications Final statement and notification" - http://www.ofcom.org.uk/consult/condocs/fin_reporting/fin_report_statement/finance_report.pdf

"publish the Regulatory Financial Statements and any corresponding audit opinions within 4 months after the end of the period to which they relate"

As the RFS periods run from 1st April to 31st March, then BT should publish its regulatory accounts by 31st July in any given year.

3.7 In previous years, BT has been granted extensions to this deadline by Ofcom but, typically, this has occurred after a period of consultation and in order for BT to adjust its accounts in response to changes in their regulatory accounting obligations. However, this was not the case in 2008. BT finally published the RFS 07/08 in September. We understand that Ofcom's work on the proposed AISBO charge control had started several months earlier using the RFS 06/07 which were subsequently re-stated within the RFS 07/08.

Ofcom has said that BT should not be allowed to benefit from the delays

3.8 In the Leased Line Charge Control consultation, Ofcom states that:

"we were intending to publish a consultation document on the leased lines charge controls in early summer, with a view to issuing a Final Statement prior to 30 September." [13]

And that:

"..certain material developments required us to amend the implementation timetable for the charge control. As discussed in Section 4, the material developments include BT's restatement of the TI (and AI service) revenues in the 2006/07 RFS and the need for us to get these restatements reviewed by third party independent consultants." [14]

3.9 Ofcom goes on to explain that:

"The delay will also push back the implementation of the charge controls for currently uncontrolled services such as AISBO and TI trunk services." [15]

3.10 Ofcom outlines its stance on the implications of the delay by stating:

"We also believe that BT should not benefit as a result of the delay, and that other stakeholders are on average no worse off than they would have been had the delay not occurred."[16]

Price reductions finally became effective on 1st February 2009 but Openreach reneged on its promise to backdate the new pricing

3.11 On the 24th November 2008, Openreach announced substantial reductions in its Ethernet prices. After a consultation into whether Ofcom would waive the 90 day

[13] Paragraph 7.2
[14] Paragraph 7.3
[15] Paragraph 7.5
[16] Paragraph 7.6

notification obligation for these price reductions[17], the new, lower pricing became effective on 1st February this year. During this waiver consultation, Ofcom estimated that the savings to Openreach's customers, based on annual rental only, from the lower prices was in the region of £56m per annum.[18] In the Leased Line Charge Control consultation, Ofcom estimate that these reductions equate to £80m across the AI basket.[19]

3.12 We also note that, in its final statement on the 90 day waiver notification, Ofcom says, in response to respondents requests for the new pricing to be backdated to 1st October 2008, that:

> *"Issues relating to the timing of the introduction of the new charge controls for leased lines are addressed in the LLCC Consultation."* [20]

Openreach's price cuts effectively pre-empted enforced one-off pricing adjustments by Ofcom prior to the start of the charge control

3.13 In the Leased Line Charge Control consultation, Ofcom says that, in light of the size of the price reductions for Openreach Ethernet services, there is no requirement for further one-off reductions prior to the start of the charge control (1st October 2009).[21] Clearly, Ofcom believes that the latest pricing reductions obviate any requirement for the one-off reductions that it was initially considering. This is despite the fact that Ofcom believes that the charges for certain services may still be outside their LRIC ceilings.[22]

3.14 So, given the above, we consider the delayed introduction (from 1ST October 2008 to 1st February 2009) of lower Openreach Ethernet prices is hard to justify. In fact, Ofcom explicitly states that, even after the new price reductions, it considers individual charges may still fail first order tests for cost orientation (an SMP condition that has been in place since at least 2004) and that ROCE across the AI basket will be between 20% and 30%.[23]

3.15 In summary, Openreach's new pricing for Ethernet should be backdated to 1st October 2008 unless Ofcom can demonstrate that, in order to account for the delays, either it has adjusted the charge control glide path or that the scale of pricing reductions was explicitly made larger. To do otherwise, would send the wrong signals to BT that it can financially benefit from breaching its regulatory obligations to the publish its RFS on time and to offer Ethernet services at cost oriented prices.

4. Technologically neutral model could allow too much scope for over-recovery

4.1. As 21CN Ethernet is low risk and offers very significant cost savings, Ofcom's proposed technologically neutral approach to the AISBO charge control offers BT too much scope

[17] http://www.ofcom.org.uk/consult/condocs/btprice/
[18] Paragraph 2.35
[19] Paragraph 5.42
[20] Paragraph 3.18
[21] Paragraph 7.15
[22] Paragraph 5.44
[23] We note that, within the LLCC, Ofcom estimates ROCE of 26% based on 2007/07 FAC but elsewhere makes adjustments for the purposes of setting base year costs for the AI charge control that effectively put ROCE at 20%

for supra-normal profits. However, we recognise that it may not be possible to base the charge control on the true costs of 21CN Ethernet at this stage as it is only just being rolled out. Therefore, we recommend that Ofcom sets the glide path for the AI charge control relatively steeply in order to counter the risk of high returns at Openreach i.e. at the far end of Ofcom's proposed indexation range.

4.2. Under Ofcom's proposed approach cost projections are calculated on the basis of current generation, point-to-point Ethernet services (like WES and BES) irrespective of whether more efficient 21st Century Network[24] products (such as Connectivity Services)[25] are used.

4.3. In theory, such an approach incentivises and rewards BT for adopting new, more efficient Ethernet services whilst protecting downstream CPs from potentially high early-life prices that could result from initially low circuit volumes absorbing high set-up costs. In practice, however, a model such as this would only work well when the newer technology offers modest cost reductions or investment is risky. In such cases, incentivising an SMP operator to adopt new technology through the charge control structure can help overcome inertia, but 21CN Ethernet offers significant cost reductions and is not risky.

4.4. The costs of next generation Ethernet will be considerably cheaper than current generation Ethernet due to the shared, aggregated nature of these services. Whilst there maybe increased costs in deploying the aggregation equipment in the BT's network, these will be far outweighed by off-setting scale and scope economies from increased sharing of duct and fibre.

4.5. There are two types of risk to consider in these circumstances; technology risk and demand risk. Of the former, it should be borne in mind that there in nothing inherently new in the technology design of 21CN Ethernet; it's just that Openreach has not offered services in this way before. The technology itself is tried and tested and does not require major changes in the way that Openreach operates in order to support it.

4.6. Given that communications providers have been requesting services akin to 21CN Ethernet for several years and that Openreach's own forecasts[26] show large take up of these services over the period of the proposed charge controls, we do not consider that there is any significant risk for BT in deploying these new services.

4.7. In theory, BT should be able to enjoy returns in excess of its cost of capital from the proposed charge control structure as long as it is successful in supplying 21CN Ethernet in scale through new acquisition, as well as migration from current generation Ethernet. It is clear from Openreach's projections that they expect scale adoption to be easily achievable over a relatively short time period. If this is the case, then there is considerable scope for higher profits during the charge control period.

4.8. Therefore, it is not possible to say at this stage whether or not there will be a requirement for one-off adjustments from the start of any subsequent charge control

[24] BT's 21CN Ethernet products are more efficient by exploiting greater economies of scope and scale as a result of increased circuit aggregation and infrastructure sharing.
[25] Ethernet Backhaul Direct ("EBD") and Bulk Transport Link ("BTL")
[26] Pages 113-115, Leased Line Charge Control consultation

period (from 2012/13). Given pent-up demand for lower priced Ethernet products and the fact that specific start up costs for 21CN Ethernet will predominantly relate to equipment as opposed to duct and fibre, we suspect that it is probable that there will need to be one-off reductions.

4.9. We are very concerned that Openreach's Ethernet customers will continue to pay prices that are not truly cost oriented. The danger with the technologically neutral approach proposed by Ofcom is that, by the end of the control, Openreach will have enjoyed returns in excess of its cost of capital for most of the 8 years between 2004/05 and 20012/13 (or, potentially, 12 years if there is a subsequent control without one-off reductions).

5. The world has changed since Ofcom's initial analysis

5.1. In our response to the Financial Framework Review, we said that the macro-economic climate has deteriorated markedly since Ofcom started its analysis and, as such, it should revisit its base year calculations and cost projections in light of the latest available data. This point is equally relevant to this consultation.

5.2. It is clear that the world has changed dramatically over the last few months and, as an evidence-based regulator, Ofcom has a duty to revisit its analysis to account for material changes to commodity and energy prices, asset prices and wage costs. There is a strong case for lower base year starting costs then Ofcom initially expected when it first conducted its analysis.

5.3. Indeed, only this week, The Times reported that BT was to impose a wage freeze for all its employees[27]. These developments cannot be ignored as they are out of step with the input assumptions used by both BT and Ofcom in forecasting future costs for the purposes of the charge control.

5.4. We refer Ofcom to Sky's latest response to the Financial Framework review for full details but, in summary, we showed how out of step BT's and Ofcom's initial expectations were in light of the:

- dramatic falls in commodity and energy prices over recent months; and
- large scale downward adjustments in the latest wage inflation expectations.

In assessing the base year starting costs and glide path for the AISBO charge control, Ofcom will need to ensure that its calculations take stock of these developments.

5.5. We also noted that there was unprecedented volatility in the financial markets and that, for the purposes of setting BT's cost of capital, the most pragmatic and reasonable approach to this volatility would be to base input assumptions on data from a more stable period. Whilst there is a clear consensus that lower commodity prices are here to stay, there is less certainty around how these financial assumptions will change.

[27] Page 44, The Times, 12th March 2009

6. Ofcom's range of efficiency improvements is insufficiently ambitious

6.1 With respect to the AISBO charge control, Ofcom has chosen to employ exactly the same efficiency range that is being proposed under the Openreach Financial Framework Review. It has not, however, justified this objectively. The cost efficiency targets set for the purposes of copper access charge controls are peculiar to those markets. Within the Financial Framework Review, Ofcom discusses which Openreach costs are controllable and which are not. Ofcom, rightly or wrongly, chooses to set an efficiency factor only against those costs that it feels Openreach can control. Some of the uncontrollable costs are specific to copper access and not to AISBO, such as line cards.

6.2 Even if there were sufficient similarities between AISBO and copper access to warrant the same efficiency target, we think Ofcom's efficiency targets are too conservative.

6.3 In our response to the Openreach Financial Framework Review and supporting KPMG analysis of efficiencies, we said

> "*Ofcom considers that efficiency gains in the range of 2-4% per annum should be achievable on costs controllable by Openreach (and that these costs themselves make up about 70% of Openreach's total costs). There is strong evidence that this is insufficiently ambitious, for four reasons.*
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> *Ofcom's own evidence suggests a higher efficiency target is appropriate. Ofcom bases its assumption on a benchmarking study carried out by KPMG. KPMG's study found that Openreach would need to make efficiency gains of 3.2 – 3.5% cumulatively per annum between 2008 and 2013 on its total operating cost base to bring it into line with an organisation operating in a competitive environment. This translates to over 4% annual efficiency on* controllable costs which is above the upper bound of Ofcom's proposed range.
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> *KPMG's report specifically excludes the possibility of current task times being too long. Given this shortcoming, we think that the real target efficiency range should be much higher. The KPMG range is still below BT Group efficiency levels (both achieved and forecast) and considerably lower than the ranges achieved by other communications providers and included in their responses to the first consultation*
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> *However, the KPMG range is closer to Openreach's historical performance. Ofcom and Openreach appear to have decided that it will not be possible to maintain these efficiency levels in the future but no evidence is presented in order to substantiate this assumption. This is counter-intuitive. The opportunity for greatest efficiency occurs when there is considerable growth in a particular product or service.*

Furthermore, we added:

> *Ofcom's fault rate assumption is likely to be too conservative. We understand that the way Ofcom and KPMG have calculated their efficiency projections is to assume a constant fault rate, and separately to calculate the impact on*

Openreach's costs of a declining fault rate. There are a number of reasons for thinking that the 4-6% fault rate reduction assumed by Ofcom is too conservative.

6.4 It is not clear how Ofcom have approached fault rates in the Leased Line Charge Control consultation, but, Ofcom's approach in the Financial Framework Review was to look at efficiencies from reduced fault rates separately to other efficiencies. If the efficiency targets proposed for AI services by Ofcom do not include the separate fault rate reduction, then some adjustment for reduction in faults will need to be included.

6.5 In our response to the Financial Framework Review, we outlined our concerns with Ofcom's proposed range for fault rate reductions. Some of our arguments appear relevant to the Leased Line Charge Control. We said:

"We note that Ofcom and BT are discussing the possibility of delaying or relaxing some of BT's OSS separation obligations that were set in the Undertakings. The OTA is already brokering industry sessions aimed at identifying alternative initiatives on which Openreach could focus its freed-up resources. We expect much effort to be diverted away from OSS separation and into fault rate improvement programmes that will deliver material improvements in fault rates."

6.6 We made further comments regarding the disparity between Openreach's projected efficiencies and those outlined by BT Group as a whole:

"BT itself is indicating to its investors that it believes there to be significant scope for further efficiencies. In November 2008, it announced 10,000 staff redundancies – 4,000 of them had already been made with a further 6,000 to complete by March 2009. It was not clear from BT's announcement what proportion of these job cuts were to be in Openreach. BT has stated its intention to achieve 4.6% efficiency savings for 2008/'09. In its interview with Michael Rake (BT Chairman) on 25 January 2009, the Sunday Times wrote "Will there be more redundancies at BT? Yes, [Michael Rake] says. BT's already losing 4,000 of its 110,000 salaried workforce, and there will be more, though he's hoping for "imaginative" solutions rather than straight lay-offs." It is important that Ofcom understand the impact of this efficiency drive on Openreach's costs.

Clearly, there are inconsistencies within BT on the scope for future efficiency which Ofcom needs to resolve; BT Group as a whole is expecting to achieve efficiencies of 4.6% this year, it is indicated that there are more efficiencies to come, Openreach has achieved significant historic efficiencies, and yet BT is maintaining that the scope for future efficiencies at Openreach are between zero and 1%.

Even were Ofcom to conclude that the bulk of BT's future efficiencies will occur outside of Openreach, this conclusion is still pertinent to Ofcom's analysis. A substantial proportion of Openreach's costs are an allocation from Group. Yet Ofcom has accepted BT's projections of certain Group costs significantly in excess of this year's group-wide target of 4.6% efficiency. For example, corporate overheads (£180m allocated to Openreach in 2008/09) are assumed to inflate at 3% per year with only 1% efficiency savings. Accommodation costs (£105m allocated to Openreach in 2008/09) are similarly assumed to inflate at 3% per *year with only 1% efficiency savings (in spite of the slump in the commercial property market). This begs the question: if BT Group-wide 4.6% target is not coming from Openreach, or from many of the Group costs allocated to Openreach, where is it coming from? It does not seem plausible that it would all come from outside of Openreach and Group. Ofcom should therefore look more critically at its assumptions for efficiency savings in Group costs allocated to Openreach."*

7. Other points of detail

Problems with the financial evidence

7.1. There is continuing uncertainty over the reliability of BT's RFS for both 2006/07 and 2007/08 (despite BT re-stating its 2006/07 accounts in 2008). As Ofcom uses BT's RFS as a basis for setting base year starting costs and for assessing compliance with charge controls and cost orientation obligations, the lack integrity in the regulatory accounts is a cause for concern.

7.2. We know that Ofcom is aware of these issues and the additional rigour it must apply when taking this base data and making adjustments before setting the charge control.

BT's incentives

7.3. In terms of the actual level of the charge control and base year costs proposed by Ofcom, it is difficult for Sky to comment fully as neither BT's RFS nor Ofcom's own analysis provide sufficient detailed information. Whilst we do not believe that communications providers themselves should have access to all BT's data, there will naturally be a degree of information asymmetry between BT and Ofcom and, therefore, it is important that Ofcom, as an evidence-based regulator, is fully cognisant of BT's incentives. These include incentives to:

- over-capitalise in order to reduce ROCE
- load cost away from unregulated products into regulated products
- over allocate group costs to Openreach
- understate future efficiencies.

7.4. Indeed, Openreach appears to have acted, intentionally or otherwise, on some of these incentives.

7.5. In the Financial Framework Review, Ofcom has identified a suite of unregulated services that make either a reduced or zero contribution to common costs[28]. Some of these services are specific to copper; others are more generic like Time Related Charges (TRCs). We note that Ethernet related TRCs would fall within the AI Ancillary basket.

7.6. We expect Ofcom to ensure that both unregulated (such as Ethernet services over 1Gb/s) and regulated products relevant to AISBO and TISBO make a reasonable contribution to common costs.

[28] Table 10.8, page 221, "A New Pricing Framework for Openreach – second consultation"

7.7. It is appropriate that a share of BT Group costs should be allocated to Openreach, however, because they are incurred outside of Openreach, neither the level of these costs nor their future projection has received the same level of scrutiny as Openreach's own costs

7.8. As we set out in our response to the Financial Framework Review, BT has an incentive to allocate costs to the regulated part of its business. One example of this behaviour could be demonstrated by the contradiction between BT Group's overall efficiency target and the efficiencies assumed to apply to those elements of Group costs allocated to Openreach.

7.9. For all these reasons, it is appropriate for Ofcom to be diligent in its assessment of Group costs, and to conduct a further review of these costs before making its final determination.

Allowing greater returns on LLU backhaul through a higher WACC because of NGA is inconsistent with Ofcom's chosen approach.

7.10. In Ofcom's recent statement on Next Generation Access[29], it has indicated that BT will be allowed some pricing flexibility for NGA. This flexibility negates the requirement for increased risk premia through a heightened cost of capital. As such, there is no need to apply a higher WACC for AISBO services to account for a proportion these services being used entirely or partially to convey NGA data.

7.11. In fact, where Ethernet circuits are being used for current generation and next generation broadband, it may be impractical to apply differential charging. We consider that it would be more practical for BT to recover its NGA costs through access related NGA components as opposed to backhaul.

7.12. Even if an argument could be constructed to warrant a higher Ethernet backhaul cost of capital due to the conveyance of NGA data, by applying it against all Ethernet services in the manner proposed by BT would result in NGA cost recovery from other, unrelated services.

SLG Payments

7.13. We commented in our response to the Financial Framework Review on the appropriate level of cost recovery of SLG payments. We said:

> *"During 2007-08 Ofcom, the OTA, industry and Openreach worked very hard to deliver a new SLG regime that properly incentivises performance. The work was undertaken in response to serious concerns at the low performance levels at Openreach and relatively weak SLG terms. A central principle that underpins the regime is that Openreach is not able to recover SLG costs when performance is worse than what would reasonably be expected from an efficient operator. To allow BT to recover costs related to continued poor performance undermines this approach.*

[29] Paragraph 8.4, "Delivering Super-fast Broadband in the UK"

We accept this principle, and therefore the pertinent question is "what is a reasonable level of performance?" Whilst this is not an easy exercise, we are generally supportive of target performance levels that have been set by the OTA and support Ofcom's proposal to adopt these in relation to SLG cost recovery. Payments made by Openreach above these benchmarks should not be recoverable. Reduced payments as a result of performance below the threshold can be recovered as this will exact as an additional incentive of Openreach.

Any argument that all SLG payments above the threshold should be recoverable in order for Openreach to invest further in service improvement is clearly flawed as there is no guarantee that recovered costs will be ploughed back into service improvement programmes especially absent any financial incentives on Openreach to do so."

Pension costs

7.14. Equally pertinent to this review as it is to the Financial Framework Review is the treatment of pension costs. Again in our response to the latter review, we stated:

"In November 2008, BT announced a number of changes to its pension fund, which it expected to realise up to £100m a year of cost savings. On 11 November 2008, union leaders announced support for these changes. BT is to increase retirement ages, calculate pension based upon average rather than final salary, and increase the number of contributions required. In its evidence – submitted before these changes - Openreach accounted for pension costs at 19.5% of pensionable pay, and this forms the basis of Ofcom's calculations too. This is clearly a material change .....It is important that Ofcom considers the impact of these changes on pension costs before finalising Openreach's regulated prices."

8. Conclusion

8.1. So, in conclusion, Ofcom's proposals and Openreach's recently announced Ethernet price reductions go some way to address historically high pricing and its detrimental impact on businesses and consumers, However, the price cuts should have been introduced much sooner. The previous cost orientation obligation has been completely ineffective in protecting Openreach's customers from high prices and nothing in Ofcom's proposals compensates for this.

8.2. Indeed, there is a real danger that, if Ofcom does not take stock of recent macroeconomic developments and is too lenient when it sets the glide path for the AISBO charge control, wholesale Ethernet customers will continue to pay prices that are entirely out of step with costs.

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