



**RESPONSE OF BSKYB TO OFCOM'S DRAFT DETERMINATION TO RESOLVE A DISPUTE BETWEEN, AMONGST OTHERS, BT AND BSKYB REGARDING BT'S CHARGES FOR ETHERNET SERVICES**

**EXECUTIVE SUMMARY**

1. It has been almost two years since British Sky Broadcasting ("**Sky**") and TalkTalk Telecoms Group ("**TalkTalk**") made a request to Ofcom pursuant to section 185 of the Communications Act 2003, for Ofcom to resolve a dispute relating to charges for backhaul extension services ("**BES**"). There are various reasons why it has taken almost two years for Ofcom to reach the point of almost resolving the dispute – though we are of the firm view that BT is largely responsible for the delay. Whatever the reasons for the delay, it is abundantly clear that it is the innocent counter-party purchasers of BES and wholesale extension services ("**WES**") that have suffered adversely as a consequence of: (i) BT's various breaches of its regulatory obligations, and (ii) the delay in the repayment of the overpayment.
2. BT is subject to 'SMP-based' regulatory obligations in respect of BES. That is clear. Yet at various times throughout the life of the BES product – from the first time Sky raised its concerns with BT over its BES pricing, to initial discussions around terms of the standard BES contract (when BT refused to delete the contractual exclusion on the payment of interest) and most recently the delay to the resolution of the dispute (BT's request to extend by one month the deadline for submissions to the draft determination) – BT has not acted in accordance with its obligations. That cannot be right.
3. BT should be held to its regulatory obligations. It should not be permitted, in the light of the relevant finding of significant market power ("**SMP**") and the associated conditions to which it is subject, to disregard its obligations. Nor should it be permitted, as has been the case here, to 'string out' the dispute process such that it may benefit materially from its own failure to comply with its regulatory obligations.
4. It is important that Ofcom issues its determination as quickly as possible, having taken into account the various submissions it receives. Any further unwarranted delay to the process will deprive communications providers of rightful reimbursement of the overpayments made to BT. Sky therefore welcomes the statement made by Ofcom that

*“we remain cognizant of the concerns expressed by respondents about the detrimental effect of delay and the need for the disputes to be resolved expeditiously.”<sup>1</sup>*

*Sky’s agrees with much of the Draft Determination, though there are two main issues with which it disagrees*

5. In respect of the draft determination issued by Ofcom on 9 February 2012 (“**Draft Determination**”), Sky agrees with Ofcom’s overall finding: namely, that BT has failed to demonstrate that its charges are cost oriented and that BT has overcharged significantly for the services in dispute.
6. There are, however, two main areas of Ofcom’s provisional conclusions with which Sky does not agree and which Sky highlights here.
7. The first main area of disagreement relates to Ofcom’s proposed approach to determining whether BT’s charges were cost oriented. It is notable that Ofcom considers the Distributed Standalone Costs (“**DSAC**”) test to play a “*central role in determining whether BT overcharged its external customers*”<sup>2</sup>. Previously both Ofcom and Oftel expressed the view that the DSAC test was a ‘first-order’ test and that it should not be applied ‘mechanistically’. Sky trusts that Ofcom is not resiling from its previous position and that the reference to “*central role*” is merely infelicitous drafting on Ofcom’s part.
8. Sky agrees that DSAC has some merits in assessment of cost orientation, but that it should not be applied mechanistically. In this case, if all BES services were priced at DSAC then BT would have the opportunity to over-recover its common costs. For DSAC-based BES pricing to be reasonable, other services sharing the same common costs would need to have made justifiable off-setting lower contributions to the recovery of common costs. Sky has seen no evidence of this off-setting effect (which would be necessary to justify setting charges at DSAC and BT still being compliant with its obligations to demonstrate its charges – including its mark-ups for common costs – were cost oriented). Sky considers that, in this instance, Fully Allocated Costs (“**FAC**”) can and should be used as a cross-check to DSAC in order to reach an informed view on the appropriate extent of the overcharge in order to ensure that BT is not afforded the opportunity to over-recover its common costs.
9. For the above reasons, ultimately settling upon FAC to determine the level of overpayment by communications providers would be the appropriate course in relation to this dispute. This is not a trivial matter. The level of over-recovery (or welfare loss) is materially influenced by whether DSAC or FAC is applied as the cost orientation ceiling. In this case, RGL estimate that the industry overcharge could increase from £120 million to £240 million were a FAC-based measure to be adopted<sup>3</sup>.

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<sup>1</sup> Letter from Neil Buckley (Director of Investigations at Ofcom) to Matthew Marsh (Senior Legal Advisor at Sky), dated 26 March 2012.

<sup>2</sup> Paragraph 9.49 of Ofcom’s Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT’s charges for Ethernet services, dated 9 February 2012. <http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf>.

<sup>3</sup> RGL review of Ofcom’s draft Ethernet determination, dated 20 April 2012, page 56.

10. The second main area of disagreement relates to the level of interest due to communications providers. Ofcom's provisional conclusions require BT to pay no interest on the overpaid monies. If this provisional conclusion is made final, BT will realise a material financial benefit from its own breach. It cannot be right that BT can breach its regulatory obligations, 'string out' a dispute worth many millions of pounds over many years; yet retain the benefit of being in receipt of the overpayments, which can (as here) be worth millions of pounds.
11. Were Ofcom to permit BT to retain the benefit it will be incentivised in the future to overcharge customers for its regulated products and to delay resolution of any dispute through filibuster and/or any legal processes available to it, safe in the knowledge that it can retain the benefit of being in receipt of the overpayments. Given the specific circumstances of this case (the fact that attempts to persuade BT that interest should be paid on overpayments were resisted when the BES agreement was put in place, the extended duration of the dispute, the material sums at stake, the distortive effects and the adverse incentives that could play-out in the event that BT is permitted to retain the benefit of its overcharge) it is appropriate that BT compensates the relevant communications providers.
12. The decision in the Draft Determination by Ofcom to permit BT to rely upon a contractual exclusion that permits BT to not pay interest on any overpayment award made by Ofcom is wrong. Ofcom is not obliged to apply the contractual interest rate and nor should it do so. Indeed, as Sky and TalkTalk stated in the dispute reference document the contractual exclusion is in breach of BT's obligations (SMP condition HH1.2) to provide Network Access (including BES) on "*fair and reasonable*" terms. Ofcom has failed to address the issue of whether, in the circumstances of this case, the contractual exclusion is a fair and reasonable term. It clearly is not.
13. Sky considers that the appropriate approach to interest is for Ofcom to determine, and issue a direction that, the contractual exclusion be disregarded and to determine itself the appropriate amount of interest that is due to communications providers. Sky advocates a restitutionary approach, as such an approach has the effect of requiring BT to disgorge itself of the benefits of being in receipt of the overcharged monies.
14. In summary, Sky agrees with and supports many aspects of the Draft Determination. It is important, nevertheless, for Ofcom to reconsider its provisional conclusions in respect of: (i) the test it uses to determine the level of overpayments by communications providers, and (ii) the compensation due to communications providers. Having reconsidered these provisional conclusions, Sky urges Ofcom to: (i) ultimately settle upon FAC as the appropriate test to determine the level of overpayment, and (ii) to award compensation to communications providers on a restitutionary basis.

## SECTION 1- BACKGROUND

15. In July 2010, Sky and TalkTalk made a request (“**Dispute Request**”) to Ofcom pursuant to section 185 of the Communications Act 2003, for Ofcom to resolve a dispute relating to charges for BES provided by British Telecommunications plc. (“**BT**”) to Sky and TalkTalk between 24 June 2004 and 31 July 2009 (the “**Dispute Period**”).
16. In its Dispute Request, Sky sought, amongst other things:
  - (i) a finding by Ofcom that BT had overcharged Sky in respect of the BES Services;
  - (ii) a direction from Ofcom to BT requiring BT to repay Sky not only in respect of the overcharging but also the financial benefit it has acquired through the possession of the overpayments; and
  - (iii) a finding that BT has breached various of its SMP obligations.
17. On 9 February 2012, Ofcom issued its Draft Determination, by which it proposed to resolve the dispute. In the Draft Determination, Ofcom proposes to conclude that BT has overcharged, amongst others, Sky for certain BES services and to direct BT to make repayments of the amounts that it has overcharged.
18. Sky wishes to make clear at the outset that it agrees with Ofcom’s overall finding: namely, that BT has failed to demonstrate that its charges are cost oriented and as a result of which BT has overcharged significantly for the services in dispute. There are, however, a number of provisional conclusions with which Sky does not agree.

## SECTION 2 – OFCOM SHOULD FIND THAT BT OVERCHARGED FOR ALL BES SERVICES

19. BES are Ethernet-based, high speed, permanently connected point-to-point data circuits which provide a secure, dedicated fibre optic link between equipment located in a BT exchange owned by a local loop unbundling (“**LLU**”) operator and its core network. BES services are of critical importance to LLU operators and are purchased predominately to facilitate the provision of broadband and voice services to an LLU operator’s customers.
20. As Ofcom identifies in the Draft Determination, Sky acquired from BT a number of BES products/services (collectively, the “**BES Services**”) during the Dispute Period, including:
  - BES 100 rental;
  - BES 100 connection;
  - BES 1000 rental; and
  - BES 1000 connection;
  - BES 10000 rental; and
  - BES 10000 connection.
21. Within the Dispute Request and on subsequent occasions, Sky provided to Ofcom evidence to support its submissions that BT had overcharged Sky for BES Services. Sky

is pleased that Ofcom concurs with its submissions that Sky has overpaid BT in respect of a number of BES products. Whilst Sky agrees with Ofcom’s provisional finding that BT overcharged Sky for BES 100 and BES 1000, Sky does not agree with the approach adopted by Ofcom in relation to BES 10000. Further detail about why Ofcom should reconsider its provisional conclusion on BES 10000 are set out at **Annex 1**.

### SECTION 3 - THE SMP CONDITIONS

22. Ofcom made findings that BT has SMP in a number of different markets in which it supplies other communications providers, including the alternative interface symmetric broadband origination (“**AISBO**”) market(s) in which it provides BES.<sup>4</sup> As a consequence of these findings, Ofcom imposed SMP-related regulatory conditions on BT (“**SMP Conditions**”).
23. These SMP Conditions fix BT with various obligations, including a ‘Basis of Charges’ obligation (Condition HH3), effective from 24 June 2004, which required BT to:
 

*“secure, and [be] able to demonstrate to the satisfaction of Ofcom, that each and every charge offered, payable or proposed for Network Access covered by Condition HH1 is reasonably derived from the costs of provision based on a forward looking long run incremental cost approach and allowing an appropriate mark up for the recovery of common costs including an appropriate return on capital employed”* (the “**Cost Orientation Condition**”).
24. The objective of the Cost Orientation Condition is to ensure that BT is unable to over or under charge for BES - and thereby prevent BT from distorting downstream competition - whilst at the same time allowing BT an appropriate return on capital employed.
25. The effect of the Cost Orientation Condition, as Ofcom rightly points out, so far as is relevant for present purposes, is to:
  - (i) require BT to secure that “*each and every*” of its charges for BES are derived in accordance with the Cost Orientation Condition; and
  - (ii) fix BT with the burden of demonstrating that its charges have been, and are, compliant with the obligations contained within the Cost Orientation Condition.
26. In addition to the Cost Orientation Condition, BT is also required to ensure compliance with SMP Condition H1.2, which states that the “*provision of Network Access... shall be provided on fair and reasonable terms, conditions and charges and on such terms, conditions and charges as Ofcom may from time to time direct.*” (the “**FR Condition**”).

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<sup>4</sup> Ofcom determined (at paragraph 10.7 of its Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets, dated 24 June 2004 - [http://stakeholders.ofcom.org.uk/binaries/consultations/llmr/statement/state\\_note.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/llmr/statement/state_note.pdf) and then in section 7 of its Business Connectivity Market Review, Review of the retail leased lines, wholesale symmetric broadband origination and wholesale trunk segments markets, dated 8 December 2008 - <http://stakeholders.ofcom.org.uk/binaries/consultations/bcmr08/summary/bcmr08.pdf>) that BT has SMP in various markets for the provision of digital leased lines, including a market in which BT provides BES products to third parties.

27. Put simply, to ensure compliance with the FR Condition, BT must, amongst other things, ensure that the contractual terms and conditions for the products and services (that are the subject of the FR Condition) are both fair and reasonable.
28. As Sky contended in the Dispute Request (paragraphs 63-70), the clause in the standard BES Agreement (clause 12.3) which has the effect of excluding the payment of interest on sums that Ofcom directs BT to pay to a communications provider in the event of an overcharge is neither fair nor reasonable. This is especially true in the light of the circumstances of this particular case<sup>5</sup>. Section 8 of this response sets out in detail Sky's views on Ofcom's provisional conclusions on the issue of the repayment of interest.

*SMP conditions should ensure the protection of consumers / customers from excessive pricing*

29. Under section 3 of the Communications Act 2003, and as set out in section 4 of the Communications Act, Ofcom's principal duty is to further the interests of consumers in relevant markets, where appropriate by promoting competition. Excessively high pricing of wholesale inputs, as BT has done for BES, may result in a distortion of competition downstream. In particular, in this case, the overcharging by BT is likely to have affected the investment decisions of BT's downstream competitors. For example, amongst other things, downstream competitors may not have made available retail products (using BES) to consumers. Ensuring that BT, as the dominant provider, is unable to charge excessive prices will help to promote competition and thereby promote the interests of end users, in accordance with sections 3(4)(b) and 4(3) of the Communications Act.

**SECTION 4 - COST ORIENTATION SHOULD APPLY TO EACH AND EVERY CHARGE**

30. In its Dispute Request, Sky submitted that in determining whether BT has complied with the Cost Orientation Condition, the starting point must be the requirements set out in that condition. The Cost Orientation Condition requires that "*each and every charge ... for Network Access*" be "*reasonably derived from the costs of provision*".
31. Sky notes that in the Draft Determination, Ofcom states that it is:

*"of the view that we should consider BT's charges on a disaggregated basis i.e. we should consider whether BT has secured that each and every disputed charge is cost orientated."*<sup>6</sup> [And that:]

...

*"[Ofcom] consider that separate charges will generally provide economically meaningful signals for potential purchasers to take into account in their decisions*

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<sup>5</sup> Such circumstances include: the fact that attempts to persuade BT that interest should be paid on overpayments were resisted by it when the BES agreement was put in place, the extended duration of the dispute, the material sums at stake, the distortive effects and the adverse incentives that could play-out in the event that BT is permitted to retain the interest.

<sup>6</sup> Paragraph 8.14 of Ofcom's Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT's charges for Ethernet services, dated 9 February 2012. <http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf>.

*on matters such as which services to purchase and from which suppliers, and in investment decisions about self-provision or entry.”<sup>7</sup>*

32. The position Ofcom intends to adopt is supported by the recent judgment of the Competition Appeal Tribunal (“CAT”) on *Partial Private Circuits*. In its judgment, the CAT found that:

*“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.”<sup>8</sup>*

...  
*“...we fail to see how either Ofcom or this Tribunal could sanction an approach to cost orientation that disregarded the clear meaning of Condition H3.1.”<sup>9</sup>*

33. As Sky stated in its Dispute Request (paragraphs 39 to 40), there are, setting aside the clear wording of the Cost Orientation Condition, good reasons why a disaggregated approach is appropriate:

- customers for BES and WES purchase such products and services in different proportions. Given the different demand profiles that exist, BT should ensure that each and every charge for its BES products and services (purchased in whatever combination) are reasonably derived from the cost of provision. Unless BT does this, it will not comply properly with Condition H3.1 as BT cannot know in advance the exact demand profile for each and every one of its BES customers and thereby will not be able (in advance) to set cost oriented prices for each combination;
- economic harm will occur, through distortions in efficient consumption decisions or investment decisions and the consequent effects of such, even if the prices in aggregate for BES are not excessive (which is not the case here); and
- given the above, there is a risk of distorting competition if the Cost Orientation Condition is not applied on each and every charge (as opposed to being applied on an aggregated basis).

34. Ofcom’s approach on aggregation is correct and Sky supports the provisional conclusions in the Draft Determination on this issue.

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<sup>7</sup> *Ibid*, paragraph 8.37.

<sup>8</sup> British Telecommunications PLC v Office of Communications (Partial Private Circuits) [2011] CAT 5, dated 22 March 2011, paragraph 228. <http://www.catribunal.org.uk/238-5136/1146-3-3-09-British-Telecommunications-Plc-.html>.

<sup>9</sup> *Ibid*, paragraph 229.

## SECTION 5 - IN THIS CASE FAC (NOT DSAC) IS THE CORRECT COST STANDARD BY WHICH TO MEASURE THE COST ORIENTATION CEILING

### Summary

35. In this section, Sky explains why FAC, not DSAC, is the appropriate cost standard by which to measure the cost orientation ceiling for BES and WES. This is because:
- by definition, if all BT's prices were set at DSAC then BT would significantly over-recover its common costs;
  - if BES and WES prices were priced at DSAC, BT would significantly over-recover its common costs unless there was sufficient off-setting lower contributions to relevant common costs by non-AISBO services;
  - Sky is not aware of any evidence of non-AISBO services being priced in this way;
  - even if there were, the Cost Orientation Condition requires that BT demonstrates this to the satisfaction of Ofcom;
  - from the evidence presented in the Draft Determination, BT does not appear to have offered such evidence, nor has Ofcom provided any such evidence;
  - absent any compelling evidence of off-setting lower contributions to common costs by non-AISBO services, FAC is the appropriate AISBO cost orientation ceiling because it reduces (but does not eliminate) the risk of BT over-recovering its common costs; and
  - should Ofcom conclude that FAC is the appropriate cost orientation ceiling for each and every individual charge, then the scale of the industry overcharge between 2006 and 2009 would be £240m (compared to £120m based on DSAC).

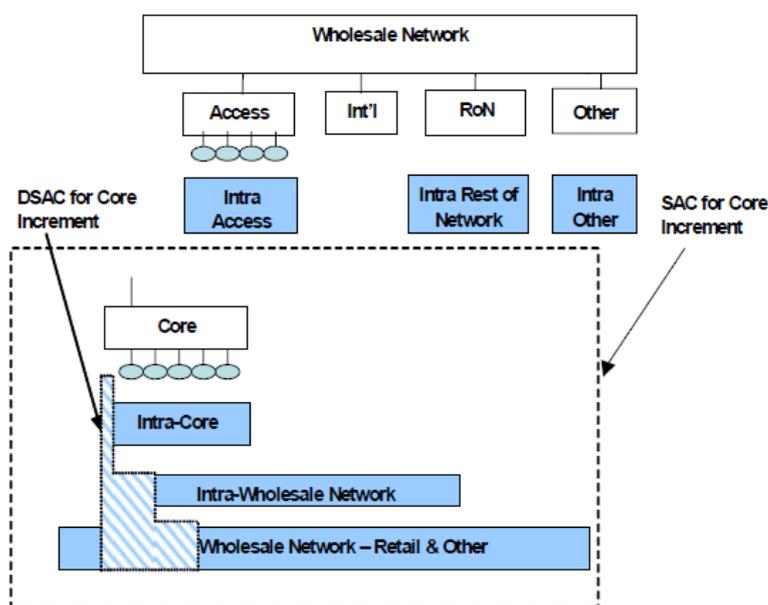
### Cost Standards

36. The objectives of wholesale price regulation include, amongst other things, protecting purchasers from excessive or predatory pricing while allowing the regulated firm the opportunity to recover its costs (including common costs).
37. Where BT has been found to have SMP, Ofcom may impose a charge control and/or a cost orientation condition. Often both are imposed but, in the case of AISBO from 2004 to 2009, there was only a cost orientation obligation in place.
38. Where there are significant fixed and common costs and long-lived assets (as there are in telecommunications networks), it may prove appropriate to allow a mark-up to long run incremental costs ("LRIC") to recover these common costs. Otherwise, the regulated firm could be disincentivised from making investments in infrastructure in the future and this will result in dynamic inefficiency over the longer term. Allowing the recovery of fixed and common costs in this way will typically result in a reduction in

demand (which represents a welfare loss) but this is necessary to preserve investment incentives.

39. Theoretically, prices based on any level of common cost mark-up could be reasonable. Where multiple services share the same common costs, the level of welfare loss that stems from the reduction in demand can be minimised by ensuring that common cost recovery is allocatively efficient. This could mean that services with relatively inelastic demand make a larger contribution to relevant common costs than those services with more elastic (price sensitive) demand. In the extreme, this could mean that the range of allocatively efficient prices for a service could be 'pure LRIC' (with no mark up for common costs at all) or standalone costs ("**SAC**", representing LRIC plus all fixed and common costs). For a service to be priced at SAC and there to be no common cost over-recovery, all other relevant services would need to be priced at LRIC.
40. While it is clear that prices for multiple products that persistently exceed SAC are likely to be excessive, where there are multiple products sharing the same fixed and common costs, it is also possible that prices below SAC could still result in the over-recovery of common costs and, as such, prices could still be excessive i.e. not cost oriented. Equally, prices above LRIC could be too low to recover all common costs.
41. In a further extreme example, where demand elasticities are all exactly the same, allocatively efficient pricing could be based upon LRIC plus an equi-proportional mark up ("LRIC+EPMU", i.e. a mark-up for common costs that is proportionate to the incremental costs of the service and where, across all products, common costs are only recovered once).
42. In its regulated financial statements ("**RFS**"), BT provides FAC data for its regulated services whereby all direct, indirect and common costs are distributed to individual services. By definition, the sum total of the FACs of all services match exactly BT's total fixed and common costs as well its incremental costs (including an allowable return on capital employed). Partly, the allocation of common costs is driven by the level of incremental costs associated with that service and, as a result, FAC estimates are taken to be a reasonable proxy for LRIC+EMPU.
43. When setting charge controls, Ofcom aims for charges to match its forecast of future efficient FACs by the end of the charge control period. The effect is to incentivise BT to reduce costs below the level forecast by Ofcom as BT is able to retain the additional cost savings. If BT were to beat the forecast level of costs, its return on capital would exceed the level set within the charge control but consumers would also gain because prices were falling.
44. When Oftel set the Network Charge Control ("**NCC**") on a basket of voice interconnection services, however, it recognised that, whilst charges in aggregate may trend to its estimates of the efficient level of FAC over the course of the charge control period, without any further constraint on the pricing of individual services within the basket, BT still had wide scope in the pricing of those individual components within the baskets (somewhere between LRIC and SAC).

45. It was at this juncture, that Oftel introduced Distributed Long Run Incremental Costs (“DLRIC”) and DSAC in order to provide a narrower set of cost floors and ceilings than LRIC and SAC. In effect, common costs are subdivided into those costs that are common to all products and services and those, more immediate (“intra-group”) common costs that are shared amongst a smaller grouping of services (although still wide enough to encompass more than one economic market). Examples, of these more immediate groups of common costs in BT’s primary accounting documentation include “Core” and “Access”.
46. If all services in the smaller group were priced at DLRIC then the immediate common costs of the intra-group would be recovered once but there would be no further contribution to the other common costs that are shared by all services. Further, the immediate intra-group costs are allocated to individual services in proportion to their incremental costs.
47. While DSAC is also calculated so that services contribute to the respective intra-group common costs so that they are recovered only once, unlike DLRIC, they also make a contribution to the wider set of common costs that are shared by all services.
48. If all services in all the intra-groups were priced at DSAC then all intra-group common costs would be recovered only once but, crucially, the wider set of common costs would be materially over-recovered. This is evident from Figure 1 below:



**Figure 1: Distributed SAC of BT’s core**  
**Source: BT Primary Accounting Documents, 28 July 2010**

49. Therefore, where DLRIC and DSAC operate as the floor and ceiling alongside a concurrent charge control on the basket of services, the pricing of individual services are constrained by the need for charges, in aggregate, to trend to a forecast of the efficient level of FAC. On the assumption that BT’s actual FACs match those forecast under the charge control, should the charge for an individual service within the basket rise above FAC (and up to DSAC), there would need to be a counter-balancing reduction

in the charge for another service within the basket below FAC (and down to DLRIC) in order to remain compliant with the overall FAC-based charge control. Even if BT's actual FACs were lower or higher than those anticipated by the charge control, it is likely that some off-setting reductions in charges would still be required.

Why DSAC does not work as a cost ceiling in this case

50. Sky accepts that, when assessing whether pricing is cost oriented or not, DSAC has some merit. As the CAT noted in its judgment on PPCs<sup>10</sup>, however, DSAC should not be applied mechanistically, it is (only) a first order test, and other cost benchmarks should also be considered appropriate.<sup>11</sup>
51. Where the cost orientation condition is applied to services within a basket, that is itself subject to a concurrent charge control (or a price cap), DSAC and DLRIC narrow the range of the possible prices of individual services within the basket.
52. However, for the AISBO basket of services between 2004 and 2009, there was no concurrent charge control in operation alongside the basis of charges condition. Absent a concurrent charge control which would have ensured the aggregate prices across the AISBO basket were at or near to forecast FAC, even if BT had priced all AISBO services at DSAC (and not above DSAC as it has systematically done in this case), it would have over-recovered its common costs unless there were off-setting lower common cost contributions from non-AISBO services.
53. While Sky accepts that, in theory, it is possible for off-setting lower contributions to remove the risk of common costs being over-recovered, for a sufficient off-setting lower contribution to occur, the downstream retail market demand for the products offered by purchasers of AISBO would have to be significantly more inelastic than the retail market demand for the products offered by purchasers of wholesale products that share the same common costs. There is no evidence of this.

The Cost Orientation Condition requires BT to demonstrate that its common cost mark-ups are "appropriate"

54. If the off-setting effect did not occur, then BT would have over-recovered its common costs. BT has failed to demonstrate that its pricing was compliant.
55. Sky considers that the wording of the Cost Orientation Condition clearly and unambiguously requires BT to demonstrate that its pricing meets its cost orientation obligations. In this case, BT has neither made the case for a DSAC approach - whereby AISBO services contribute more to common costs than other products sharing those

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<sup>10</sup> British Telecommunications PLC v Office of Communications (Partial Private Circuits) [2011] CAT 5, dated 22 March 2011, paragraph 304 - 305. <http://www.catribunal.org.uk/238-5136/1146-3-3-09-British-Telecommunications-Plc-.html>.

<sup>11</sup> This need to assess other factors is explicitly recognised by the Tribunal in its PPC judgment, in order to avoid the DSAC test becoming a mechanistic test of cost orientation - see paragraphs 295 and 305, in which the Tribunal state that DSAC should be treated "as a 'rebuttable presumption' in relation to the appropriateness of common cost allocation" and that "OFCOM acted appropriately in looking to other factors in addition to the mere fact that DSAC had been breached by BT's prices." Combined with BT's obligation to demonstrate that its charges are cost oriented, reference to FAC in this case is appropriate unless BT can demonstrate to Ofcom (and disputing parties) that BT has not over-recovered its common costs via BES and WES charges.

common costs - nor has it provided any evidence of off-setting lower common cost contributions, from non-AISBO services that share the same common costs.

56. Again, it is for BT to demonstrate that its pricing is reasonable. Without this additional requirement BT would have an incentive to price to DSAC for its services that were subject to the Cost Orientation Condition (assuming such prices rise were profitable) even though it could be over-recovering its common costs.

*In this case, the price ceiling should be FAC*

57. In summary, aggregate pricing above FAC for AISBO services could in theory be reasonable and not excessive but BT has not demonstrated this, which it is required to do. In fact, the relative elasticities of products and services in the respective downstream retail markets that are served by both purchasers of AISBO and purchasers of other services sharing the same common costs would have to be very different to justify pricing marginally above FAC (and certainly nowhere near DSAC). There is no evidence of this.
58. In this context, a more appropriate cost standard by which to measure cost orientation is FAC as it reduces the scope for common cost over-recovery and excessive pricing - which is an intended purpose of the Cost Orientation Condition.<sup>12</sup>
59. Ofcom also suggest (at paragraph 9.54 of the Draft Determination) that applying FAC as the cost orientation standard would be “rate of return regulation” whereby the allowable return or margin that BT could earn on the regulated products would be set by Ofcom. Rate of return regulation does not provide any efficiency incentives for the regulated firm because, irrespective of how much it reduces its costs, its prices also reduce accordingly to preserve the same profit margins. This differs to charge controls where prices are intended to match forecast FAC by the end of the charge control period and, as such, the regulated firm is incentivised to be more efficient and minimise costs below the forecast.
60. However, while this may be the case, it is no different to applying DSAC as the cost orientation ceiling - other than the allowable rate of return is lower. All this points to is that it is preferable, where practicable, to have a concurrent charge control in operation alongside a cost orientation condition that allows the regulated firm to “beat” the regulator’s cost forecasts and, thus, retain those gains for itself. Under such circumstances there is no requirement to assess cost orientation ceilings by reference to FAC as this is only appropriate where there is no charge control.
61. This is not a trivial matter. The level of over-recovery (or welfare loss) is materially influenced by whether DSAC or FAC is applied as the cost orientation ceiling. In this

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<sup>12</sup> A cost orientation ceiling based on BT’s actual FAC is likely to be higher than the level of prices than of a FAC-based charge control with its inbuilt efficiency factors and incentives that will reduce prices and costs year-on-year. By way of illustration, in the recent LLU and WLR charge controls forecast efficiency gains were set at 4.5% net (or 5% gross) per annum of which 3% is attributed to ‘catch-up’ efficiency. This implies that BT’s FAC costs are currently c10% above the competitive level. Therefore, assessing cost orientation by reference to FAC in this case would still be above the efficient level of costs derived from a charge control.

case, RGL Forensics estimate that the industry overcharge could increase from £120 million to £240 million were a FAC-based measure to be adopted<sup>13</sup>.

62. Finally, it is for BT to demonstrate that its charges were cost oriented. It has failed to do this.

## SECTION 6 – PURPORTED NASCENCY OF BES AND WES

63. In the Draft Determination, Ofcom explains that BT has argued that, given the nascent nature of WES and BES products (and the AISBO market within which they reside)<sup>14</sup>:

- it has been difficult to predict its costs and, hence, to ensure that its prices were cost oriented; and
- in effect, it should be afforded a “risk premium” when assessing whether prices were cost oriented.

64. BT has not provided any evidence to support these arguments.

65. Sky, nevertheless, considers that, while BES and WES services were both new and growing products, they were not sufficiently risky to warrant special treatment or leniency when assessing the cost orientation ceiling. In fact, AISBO services were (and still are) relatively lacking in risk both in terms of demand-side risk and supply-side (technology) risk.

### Demand-side Risk

66. The lack of competition (in part, as a result of high entry barriers<sup>15</sup>) to BT in the relevant wholesale market means that, to some extent, it is sheltered from the competitive risks over the size of its market share<sup>16</sup> but remains exposed to market-wide risk as to the future scale of the market. However, just because demand for AISBO services grew quickly over the past decade, this does not mean that there has been uncertainty in demand. In fact, demand has been predictable and well trailed.

67. First, BT did not have a “standing start” in providing Ethernet services. This is because for many years prior to the launch of BES and WES services in 2005, BT had been providing a precursor product known as LES which was physically and technologically identical and purchased by communications providers for exactly the same purposes (namely to provide business Ethernet connectivity services, Ethernet aggregation and LLU backhaul).

<sup>13</sup> RGL review of Ofcom’s draft Ethernet determination, dated 20 April 2012, page 56.

<sup>14</sup> Paragraphs 8.17 – 8.56 of Ofcom’s Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT’s charges for Ethernet services, dated 9 February 2012. <http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf>.

<sup>15</sup> There may have been limited scope for new entrants to deploy their own fibre networks in high density business districts, such as the City of London, in order to compete with BT in provision of wholesale business Ethernet services. However, for the relatively few LLU operators seeking ubiquitous, national Ethernet backhaul networks to (largely) residential (sub-) urban exchanges there is little prospect of effective entry and competition.

<sup>16</sup> This is borne out by BT’s relatively stable AISBO market share between the Leased Line Market Review (2004) and the Business Connectivity Market Review (2009) in spite of its scope to price excessively.

68. Indeed, once BES and WES were launched, communication providers migrated most of their LES circuits onto the new products. The migration was purely administrative in that the circuit was untouched but, contractually, was supplied by a different part of BT (Openreach) under different contractual terms and prices.
69. The effect of this migration was to ensure that BES and WES volumes were high in the first year of launch, thus, protecting BT from the risk of not recovering its costs.
70. Second, particularly in relation to BES (LLU backhaul), demand is driven by the demand for retail broadband services which were already becoming widely adopted prior to the launch of BES. Future growth for these services was not uncertain.
71. It is worth noting that, aside from LLU backhaul, the other wholesale BT products (MPF/SMPF and Co-mingling) required to provide LLU-based broadband services, were subject to individual charge controls with a lower WACC than the “Rest of BT” level (the applicable WACC for AISBO). Plainly, if demand-side risks for LLU based services were high then such an approach would not have been warranted. This demonstrates that, for LLU backhaul demand at least, BT was not facing a level of undue uncertainty that would justify a “risk premium”.
72. Moreover, as LLU roll-out requires significant investment, the relatively few large scale LLU operators had well-communicated roll-out programmes that were subject to long term forecasting (which, in part, were required to be shared with Openreach as part of the ordering process). It is simply not credible to suggest that Openreach was unaware of the scale and scope of LLU deployment and the resulting level of LLU backhaul demand.
73. Further, to the extent that there was any demand uncertainty, it would only pertain to the number of the LLU operators requiring backhaul to specific BT exchanges that they wished to unbundle. There would be little or no risk arising from increased demand for bandwidth on a per subscriber basis or per exchange because Ethernet costs are bandwidth agnostic e.g. a 100Mb/s circuit costs the same to provide as a 1Gb/s circuit.

#### Technology/Supply-side Risk

74. As highlighted above, BT had been providing identical Ethernet services (via LES) for some time prior to the advent of BES and WES and, as such, these products were established and stable. Moreover, BES and WES products are essentially very simple products based on well-established technological standards. They typically involve point-to-point fibre optic cabling that runs through BT’s existing duct network<sup>17</sup> with Ethernet termination equipment at either end. Different bandwidths are supported by different cards within the termination equipment.
75. LES, BES and WES services are not the first products in BT’s portfolio to utilise its fibre and duct network. Amongst other services, TI Symmetric Broadband Origination and call conveyance services (such as Local to Tandem conveyance) have utilised these

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<sup>17</sup> For some WES services supplied to business premises, there may be a requirement to build new duct for the “final drop” but Openreach can recover any resulting excess construction costs from its wholesale customers.

resources for many years prior to the advent of LES, WES and BES and, as such, should be well understood by BT.

76. Ethernet itself, including the termination equipment, is a long established networking technology which is deployed in most telecommunication networks. Hardware is based upon a common international technology standard, is relatively cheap compared to legacy technologies (such as ATM/SDH<sup>18</sup>) and in plentiful supply from a wide variety of established suppliers. Equipment costs have been falling over many years. Both fibre and equipment costs are “bandwidth agnostic” i.e. their costs are roughly the same irrespective of the bandwidth supplied.<sup>19</sup>

BT's approach to unit cost forecast risk and its cost orientation obligation

77. Notwithstanding these arguments that, in fact, WES and BES volumes and costs were not inherently risky or unpredictable, as part of its regulatory cost orientation obligations BT is required to price services in a manner that reflects its costs. While this will include an element of prediction as to the level of its unit costs when it sets its prices (as is the case with all pricing decisions where cost orientation obligations apply), Ofcom's approach allows for temporary breaches of any cost orientation ceiling when it assesses the duration of any potential breach (paragraph 9.39 of the Draft Determination).
78. As a result, BT is already afforded some (generous) protection from mis-forecasting its unit costs. Further, BT does not need to wait until the annual publication of its RFS in order to remedy any inadvertent breaches in pricing ceilings. BT has access to monthly/quarterly financial reporting data that should enable it to identify whether unit costs are falling below the anticipated level and, therefore, can react accordingly.
79. Either way, to the extent that BT may have had concerns that its pricing may have proved too high, it could have erred on the side of caution and priced conservatively as a result.
80. In fact, as evidenced by the PPC case, BT did not price above DSAC as a result of uncertainty in forecasting its unit costs at all. Instead, it wholly misconstrued its obligation to ensure that *each and every individual charge* was cost oriented by adopting an aggregated approach to pricing compliance<sup>20</sup>.

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<sup>18</sup> Asynchronous Transfer Mode and Synchronous Digital Hierarchy.

<sup>19</sup> Once bandwidth exceeds 1 Gb/s then equipment costs can increase.

<sup>20</sup> See paragraph 338(2) of *British Telecommunications PLC v Office of Communications (Partial Private Circuits)* [2011] CAT 5, dated 22 March 2011, paragraphs 327 and 329. <http://www.catribunal.org.uk/238-5136/1146-3-3-09-British-Telecommunications-Plc-.html>.

**SECTION 7 - IT IS UNNECESSARY TO SHOW ECONOMIC HARM, THOUGH THERE HAS BEEN ECONOMIC HARM**

81. There is no need to show economic harm in order for Ofcom to make a finding that BT has breached Condition H3.1. The CAT in its judgment on the PPC dispute made this clear:

*“the need to show economic harm – of any sort – is not a pre-requisite for a finding that Condition H3.1 has been breached” and therefore “we do not consider there to be a role for an economic harm test when Ofcom is seeking to assess whether BT has breached Condition H3.1”<sup>21</sup>*

82. Sky therefore agrees with Ofcom’s conclusion that *“On the basis of the CAT’s conclusions [as set out in the above quotation] we do not consider economic harm in these Draft Determination.”<sup>22</sup>*

83. Whilst it is not necessary to show economic harm, the overcharging by BT has caused economic harm to both communications providers as well as to consumers. The excessive BES charges are likely to have constrained the scale and pace of LLU roll-out which, in turn, will have affected when and where LLU-based services were offered to consumers. For example, where LLU operators have not been able to justify the cost of unbundling an exchange (or have delayed a decision to do so):

- (i) consumers faced higher fees for ‘off-net’ (i.e. not unbundled) products that offer low margins to such operators;
- (ii) LLU operators were unable to offer off-net consumers the same superior services that can be offered to on-net customers; and
- (iii) the LLU operator had a reduced ability to take advantage of scale economies.

84. In addition, not all communications providers competing in the same downstream retail markets purchase BES services (or if they do in the same proportions) and thereby there is a risk that competition may be distorted.

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<sup>21</sup> *Ibid*, paragraphs 327 and 329.

<sup>22</sup> Paragraph 9.30 of Ofcom’s Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT’s charges for Ethernet services, dated 9 February 2012. <http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf>.

## SECTION 8 - INTEREST

85. Ofcom determines, in the Draft Determination, that *“interest should be paid on the repayments”*<sup>23</sup> and that such interest should be payable *“in accordance with the contractual provisions entered into by the Parties.”*<sup>24</sup> Whilst Sky agrees with Ofcom’s finding that interest should be payable, it does not agree that in the present circumstances the amount of interest payable should be by strict reference to the contractual provisions of the BES contract, as Ofcom provisionally concludes. We set out below our reasons for that view.
86. Ofcom’s powers to resolve a dispute are set out in primary legislation: section 190 of the Communications Act 2003. These powers include a power to give a direction requiring a communications provider to pay a sum of money to another communications provider.
87. Ofcom can and should issue a direction under section 192(2)(b) *“fixing the terms or conditions of transactions between the parties to the dispute”*, which has the effect of striking out the clause of the standard BES agreement that excludes the payment of interest and requiring BT to include in the standard agreement a clause that entitles communications providers to interest in the event of overcharging by BT.
88. Ofcom should also issue a direction under section 190(2)(d) ordering BT to repay to Sky both the overpayments made by Sky and to put BT back in the position it would have been in but for its failure to comply with SMP Condition H3.1.

*Unless interest is payable BT will be incentivised to overcharge and await Ofcom’s resolution of disputes*

89. Sky considers that a direction requiring BT to pay interest not only puts the parties back in the position they would have been in but for the breach, it also sends BT the right message – namely, that it cannot retain the financial benefit of breaching SMP Conditions. Sky was therefore encouraged to note in Ofcom’s Draft Determination that:

*“BT should not unfairly retain any overcharge, as this could provide a disincentive for it to comply with its regulatory obligations. We believe that the incentives and regulatory signals that determinations in disputes of this nature send to BT (and other CPs) as to how we will interpret regulatory obligations and assess future conduct are of real importance.”*<sup>25</sup>

90. The CAT also held, in the PPC judgment, that repayment was simply:

*“putting the parties in the position they would have been in had Condition H3.1 been complied with. Failure to do so would undoubtedly signal that compliance*

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<sup>23</sup> *Ibid*, paragraph, 14.37.

<sup>24</sup> *Ibid*, paragraph, 14.37.

<sup>25</sup> Paragraph 14.24 of Ofcom’s Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT’s charges for Ethernet services, dated 9 February 2012. <http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf>.

*with SMP conditions is not rigorously policed and that – we consider – is an inappropriate signal to send.”<sup>26</sup>*

91. The lack of an adverse financial consequence for BT in the event it retains overpayments creates a real incentive for overcharging and this cannot be right in the light of what the SMP Conditions seek to achieve<sup>27</sup>. Further, failure to require BT to make an interest payment also incentivises BT to delay the swift resolution of disputes. As Sky set out in its response to BT’s request to extend the deadline for submissions to Ofcom’s Draft Determination, the current cost to Sky of each day’s delay in the resolution of this dispute is £[REDACTED].<sup>28</sup> Given the potentially large sums involved in disputes with BT, there is a clear risk of BT delaying resolution of future disputes (as it has in the current dispute).

*Ofcom is not obliged to apply the contractual interest rate*

92. Ofcom concludes in the Draft Determination (at paragraph 14.37) that interest should be paid on the repayments *"in accordance with the contractual provisions entered into by the Parties"*. In effect, in light of the wording of Clause 12.3 of the standard BES agreement, this means that no interest is payable.
93. The only reason given by Ofcom as to why the contractual provisions on interest should apply is that this is consistent with the approach taken in previous determinations (paragraph 14.37). The fact that the contractual rate of interest has been deemed appropriate in past cases does not mean that it is appropriate in relation to the specific facts of this case. Sky submits that there is no presumption that the contractual interest rate should apply, particularly where, as in this case, the contract actually provides that no interest is payable (unlike other BT regulated contracts). The fact is that Ofcom has directed BT to pay actual sums of interest in disputes determinations in the past, and therefore to award the Parties a restitutionary sum would be *“consistent with [Ofcom’s] previous determinations”<sup>29</sup>*. Whether or not interest is payable, and the appropriate rate at which interest should be set, are both matters which fall to be considered as part of the dispute resolution, by reference to Ofcom’s statutory duties.
94. At paragraphs 14.38 to 14.44 of the Draft Determination, Ofcom explains how its decision to require BT to repay the overpayments is consistent with its statutory duties. Sky considers that the reasons given by Ofcom as to why it is appropriate for BT to repay the overpayments also point towards BT being required to repay interest at a rate above the contractual interest rate applicable in this case. In particular, at paragraph 14.41, Ofcom refers to the fact that adjustment of overpayments supports

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<sup>26</sup> British Telecommunications PLC v Office of Communications (Partial Private Circuits) [2011] CAT 5, dated 22 March 2011, paragraphs 338(2). <http://www.catribunal.org.uk/238-5136/1146-3-3-09-British-Telecommunications-Plc-.html>.

<sup>27</sup> Even if BT is required to disgorge fully its gains from breaching its SMP obligations, it would still be incentivised to overcharge because, at worst, it is no more materially worse off than it would have been had it charged the appropriate price.

<sup>28</sup> Email from Sky (Matthew Marsh, Senior Legal Advisor) to Ofcom (Neil Buckley, Director of Investigations), dated 21 March 2012.

<sup>29</sup> Paragraph 14.37 of Ofcom’s Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT’s charges for Ethernet services, dated 9 February 2012. <http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf>.

Ofcom's obligation to further the interests of consumers, where appropriate by promoting competition, as it encourages BT to comply with its SMP obligations. This reasoning also applies in relation to the payment of interest. If BT were not required to disgorge from itself the benefit of the overpayments in this case, this would act as a further incentive on BT in future cases not to comply with its SMP obligations, as there would be no adverse financial consequence from overcharging and BT would be able to retain the benefit earned on the overpayments. Such an outcome would not be consistent with Ofcom's statutory duties.

Wording of the Draft Determination suggests that Ofcom has disregarded the contractual exclusion

95. Under the terms of clause 12.3 of the standard BES agreement, interest will not be payable on any amount due to it in the event of an Ofcom determination that there has been an overcharge. Clause 12.3 provides as follows:

*“12.3 ... If any charge is recalculated or adjusted with retrospective effect under an order, direction, determination or requirement of Ofcom, or any other regulatory authority or body of competent jurisdiction, the Purchaser Parties agree that interest will not be payable on any amount due to either party as a result of that recalculation or adjustment.”*

96. Irrespective of the wording of clause 12.3, Ofcom's decision that *“interest should be paid on the repayments”*<sup>30</sup> (as noted above, to be consistent with its approach in previous determinations) has the effect – or at least should have the effect – of disregarding the contractual exclusion on the payment of interest. Therefore, Ofcom has, in effect, determined that BT cannot rely upon part of clause 12.3.
97. Given the proposed approach by Ofcom to clause 12.3, it is unreasonable for Ofcom then to direct *“that interest should be paid in accordance with the contractual provisions entered into by the Parties....In this case, the relevant contractual provisions provide that interest will not be payable.”*<sup>31</sup>
98. It is inconsistent for Ofcom to decide that interest should be payable and thus override the exclusion, but then Ofcom allows BT to rely upon the otherwise overridden exclusion which permits BT not to pay interest. To decide this aspect of the dispute in this way would not be consistent with Ofcom's duties under section 3(3)(a) Communications Act.
99. Sky urges Ofcom to re-evaluate its provisional conclusions in relation to clause 12.3, such that BT is not able to rely upon what is an unfair restriction.

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<sup>30</sup> Paragraph 14.37 of Ofcom's Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT's charges for Ethernet services, dated 9 February 2012. <http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf>.

<sup>31</sup> *Ibid.*

It is fair that interest be paid

100. In its Dispute Request, Sky and TalkTalk stated (at paragraphs 63-70) that the contractual exclusion contained in the standard BES agreement is invalid and/or cannot properly be relied upon by BT, because it is in breach of SMP Condition HH1.2, which requires BT to provide Network Access on “*fair and reasonable terms*”.
101. Sky remains of the view that, in the circumstances of this particular case<sup>32</sup>, the contractual exclusion is invalid and/or cannot be properly relied upon on the basis that it is not a “*fair and reasonable term*” and is therefore not compliant with SMP Condition HH1.2, which provides as follows:

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

102. In determining what is meant by “*fair and reasonable*” in the current dispute, Sky is mindful that Ofcom stated in the LLMR statement (when it imposed the FR Condition on BT for AISBO services, including BES), that BT be required to publish a reference offer for AISBO services which must include: “*terms and conditions that are fair and reasonable. This will help to ensure that products are offered on terms and conditions as they would in a competitive market ...*”.<sup>33</sup>
103. Sky contends that in determining whether any of BT’s terms and conditions are fair and reasonable in the particular circumstances of this case, Ofcom should consider whether the terms and conditions would be ones that would exist in a contract for the provision of BES from BT if these BES could be purchased in a competitive market.
104. It is clear to Sky that the term which purports to exclude the payment of interest would not have been agreed had BES products been available within a competitive market. Indeed, in discussions between Towerhouse Consulting LLP – who were acting on behalf of Easynet (which, at the time was a wholly-owned subsidiary of Sky) in 2008 – and BT in relation to the contractual terms for BES, Towerhouse noted the following in an ‘issues log’ in relation to clause 12.3:

**“Concern/Comment** – C&W; *The interest should be payable from the date that the CP actually overpaid and NOT the date that it was agreed such had occurred.*

...

**Concern/Comment** – Easynet: *No interest available on retrospective price changes – can go either way but we may want interest to be incurred. To be discussed. Please explain this caveat; it is surely a hangover from the old SIA provisions which allowed provisional traffic data calculations based on CP figures. Not appropriate*

<sup>32</sup> Such circumstances include: the fact that attempts to persuade BT that interest should be paid on overpayments were resisted when the BES agreement was put in place, the extended duration of the dispute, the material sums at stake, the distortive effects and the adverse incentives that could play-out in the event that BT is permitted to retain the interest.

<sup>33</sup> Ofcom Review of the retail leased lines, symmetric broadband origination and wholesale trunk segments markets, dated 24 June 2004, paragraph 7.71 - [http://stakeholders.ofcom.org.uk/binaries/consultations/llmr/statement/state\\_note.pdf](http://stakeholders.ofcom.org.uk/binaries/consultations/llmr/statement/state_note.pdf).

*in non-switched services. In relation to fact interest will not be payable on any amount due as a result of a recalculation, CP would expect interest to be payable on this money.*

...

***Discussion at mtg of 23/1 and conference call of 31/1*** – Openreach researching the issue around retrospection and also C&W's issue about date that the refund applies from

...

***Subsequent responses / comments from Openreach*** – Openreach reject point made by C&W relating to retrospection

***Discussion/response relating to CP priority listing on 26/3 and updated for mtg of 9/4*** – Openreach reject point made by C&W relating to retrospection<sup>34</sup>

105. Towerhouse also made the following note on 27 March 2008 “*BT will not introduce a right to interest on backdated settlements following Ofcom disputes, despite doing so in their other contracts.*”<sup>35</sup> It is clear from the above that communications providers, including Easynet, requested interest to be payable on historic overcharging and that BT rejected this request.
106. Had BT not possessed SMP in relation to BES, Sky considers that it is likely that a clause providing for the payment of interest at a commercially acceptable rate could have been negotiated for inclusion in the agreement. The BES contract was not, however, freely-negotiated. Rather, the contract was in standard form – and thus there was no room for bilateral negotiations – and BT, exercising its market power, refused to accept terms requested by both Easynet and Cable & Wireless. In effect, therefore, Sky had no choice but to accept the standard terms of the BES Agreement – to which it was automatically migrated – in order to be able to obtain BES.

*Interest should be payable on a restitutionary basis*

107. Ofcom is entirely right to determine that interest should be payable. As a matter of commercial fairness, Sky considers that it is right that BT be required to disgorge fully the benefit it has obtained by breaching the Cost Orientation Condition. Sky also notes the CAT's position on the payment of interest in the PPC Judgment, in which the CAT held that:

*“Any shift away from the restitutionary approach that we have described would, so we conclude, be unjustifiable.”*<sup>36</sup>

108. The CAT also held that the restitutionary approach was simply one that was “*putting the parties in the position they would have been in had Condition H3.1 been complied with.*”<sup>37</sup>

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<sup>34</sup> Towerhouse Consulting LLP working notes of discussions with BT in relation to the draft wording of the BES agreement, see **Annex 2**.

<sup>35</sup> *Ibid.*

<sup>36</sup> British Telecommunications PLC v Office of Communications (Partial Private Circuits) [2011] CAT 5, dated 22 March 2011, paragraphs 338(2). <http://www.catribunal.org.uk/238-5136/1146-3-3-09-British-Telecommunications-Plc-.html>.

<sup>37</sup> *Ibid*, paragraph 338(2).

109. Sky agrees with the restitutionary approach advocated by the CAT, as this would ensure that BT has not been advantaged through its overcharging.

The appropriate level of interest

110. Ofcom should ensure that BT does not retain any benefit from its failure to comply with the Cost Orientation Condition.
111. Sky contends that the appropriate level of interest that BT should repay to Sky should be that which would result in BT's disgorging itself of the benefits gained from the overcharging. Sky considers that the amount of interest that it is currently due is between £[REDACTED] and £[REDACTED] (dependent upon whether DSAC or FAC is used). RGL has reached this figure on the basis of BT's WACC. The rationale for using BT's WAC is explained below.
112. Ofcom has previously directed BT to make an adjustment for an overpayment by reference to BT's WACC. In a dispute that appears to be analogous to the current dispute (namely, the PPC payment terms dispute), Ofcom directed:

*“that BT must pay THUS a sum by way of adjustment for the overpayment of charges... products and services to cover the loss incurred through the early payment of the nominal price for those products and services incurred during the period of 28 November 2003 up to and including the day before the date of this Determination. The sum shall be calculated on the basis of the total cost of capital which BT avoided as a result of BT's reduced working capital requirements caused by THUS's early payment of the nominal price of... products and services. The relevant cost of capital to be applied is BT's weighted average cost of capital for [the relevant] products and services which is 13.5% for the period of 28 November 2003 to 30 September 2005 and 11.4% thereafter.”<sup>38</sup>*

113. Sky also notes that in the dispute on PPC payment terms, Ofcom stated that:

*“4.118 ...the WACC reflected in the relevant charge control effective at the time should be used to calculate the quantum of reimbursement. This is because the amount of the adjustment should reflect the amount by which prices paid would have been lower, had the level of BT's working capital been adjusted in a way consistent with the difference between the actual payment terms and those which Ofcom has determined are reasonable.”<sup>39</sup>*

114. In effect, what Ofcom appears to have done in the PPC payment term dispute is to use BT's WACC as a proxy for Thus' loss and as a measure of BT's gain.

<sup>38</sup> Direction contained in Ofcom Determination of a dispute between THUS and BT about payment terms for PPCs, IECs and IBCs, dated 25 January 2007 [http://www.ictdec.org/en/regions/region\\_5/zone\\_177/database\\_12/decisions/219/en/219.pdf](http://www.ictdec.org/en/regions/region_5/zone_177/database_12/decisions/219/en/219.pdf).

<sup>39</sup> Direction contained in Ofcom Determination of a dispute between THUS and BT about payment terms for PPCs, IECs and IBCs, dated 25 January 2007 [http://www.ictdec.org/en/regions/region\\_5/zone\\_177/database\\_12/decisions/219/en/219.pdf](http://www.ictdec.org/en/regions/region_5/zone_177/database_12/decisions/219/en/219.pdf).

Calculating the level of interest due

115. Sky has asked RGL to calculate the amount of interest due (based on different methodologies) – a full account of the methodologies used is contained in the RGL report attached at **Annex 3**.

**SECTION 9 - IT IS APPROPRIATE FOR OFCOM TO FIND THAT BT HAS BREACHED SMP CONDITIONS HH1.2 AND HH3**

116. In order to give Sky the opportunity to most effectively right the wrong of BT's overcharging, not only should Ofcom award Sky with the appropriate amount of interest, it should also, in the final determination, make a finding that BT has breached its SMP Conditions. In particular, Ofcom should find that BT has breached:
- SMP Condition HH1.2 – for including the contract exclusion in the standard BES contract, such exclusion is not a fair and reasonable term; and
  - SMP Condition HH3 – in respect of the overcharging by BT for BES.

SKY

20 APRIL 2012

## ANNEX 1 – FURTHER INFORMATION ON BES 10000

- 1) Ofcom’s provisional decision “*to conclude that there is no dispute between BT and Sky in relation to BES10000 services*”<sup>40</sup> and not to consider the matter in any “*greater detail*”<sup>41</sup> appears to be based, erroneously, on the premise that “*no specific data*”<sup>42</sup> was provided to Ofcom in respect of BES 10000. If this is the case, then Ofcom’s premise is wrong. Ofcom has been provided with sufficient information<sup>43</sup> to enable it to determine a) there was a dispute in relation to BES 10000, and b) that it was appropriate for it to consider “*in greater detail*” the level of overcharging in relation to BES 10000.
- 2) Sky has recently trawled its invoicing records and has located various invoices from BT in relation to BES 10000. From these invoices it is possible to determine that Sky paid BT circa £[REDACTED] for BES 10000 between 14 June 2007 and 31 December 2008.
- 3) The sum of £[REDACTED] represents an estimate. The attached spread-sheet shows how Sky has reached this figure.
- 4) Sky was not invoiced for BES 10000 until February 2008. Moreover, Sky is not in possession of detailed invoices for the period 1 February 2008 to 31 July 2008, though we do have the cover sheet invoices. The invoices that Sky has are attached at **Annex 4**.
- 5) Sky considers that Ofcom should, in the first instance, review this material and if necessary request BT to provide it with information to verify the amount it received from Sky in respect of BES 10000. Sky notes that in reaching its Draft Determination, Ofcom proposes to use “*BT’s billing data*”<sup>44</sup> as the basis for determining the level of individual repayment due for overcharging of BES 100 and BES 1000 as opposed to the data provided to Ofcom by the communications providers in question. Sky contends that Ofcom could and should have used BT’s billing data for BES 10000, together with other data that Ofcom could have requested from BT in order to determine whether there had been an overcharge for BES 10000 and if so, what the level of overcharge was. In any case, it is clear that BT has failed to demonstrate that charges for BES 10000 were cost oriented.

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<sup>40</sup> *Ibid*, paragraph 7.17.

<sup>41</sup> At paragraph 7.15 of the Draft Determination, Ofcom states that it considers “*in greater detail*” BES 100 and BES 1000 (on the basis that there was a dispute in relation to these products).

<sup>42</sup> Paragraph 7.16 of Ofcom’s Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT’s charges for Ethernet services, dated 9 February 2012. <http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf>.

<sup>43</sup> For example, see the letters from [REDACTED], dated 10 January 2008 and 19 February 2008. Further, in Sky’s response of 8 April 2011 to Ofcom’s section 191 Communications Act 2003 request for information, Sky provided to Ofcom various material, including a spread sheet which set out details of the BES rentals and connections purchased from BT during the Dispute Period. Included within the spread sheet was reference to the [REDACTED] “BES 10000” connections that Sky acquired from BT at a cost of £[REDACTED].

<sup>44</sup> Paragraph 14.34 of Ofcom’s Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT’s charges for Ethernet services, dated 9 February 2012. <http://stakeholders.ofcom.org.uk/binaries/consultations/ethernet-services/summary/Ethernet-services.pdf>.

- 6) Ofcom should:
- (i) consider further whether BT did, in fact, overcharge Sky for BES 10000;
  - (ii) determine that BT did, in fact, overcharge Sky for BES 10000; and
  - (iii) order BT to make repayments to Sky in respect of such overcharging.

**ANNEX 2 – TOWERHOUSE CONSULTING LLP NOTE OF DISCUSSIONS WITH BT**

**ANNEX 3 – RGL REPORT**

**ANNEX 4 – INVOICES FOR BES 10000**