



Verizon Business  
Basingstoke Road  
Reading  
Berkshire  
RG2 6DA  
United Kingdom

20 April 2012

## **Verizon response to Ofcom's Draft Determinations to resolve disputes between each of Sky, TalkTalk, Virgin Media and Cable & Wireless and BT regarding BT's Ethernet charging**

1. Verizon Business ("Verizon") is the global IT solutions partner to business and government. As part of Verizon Communications – a company with nearly \$108 billion in annual revenue – Verizon serves 98 per cent of the Fortune 500. Verizon caters to large and medium business and government agencies and is connecting systems, machines, ideas and people around the world for altogether better outcomes.
2. Verizon welcomes the opportunity to respond to Ofcom's "Draft Determinations to resolve disputes between each of Sky, TalkTalk and Virgin Media and BT regarding BT's charges for Ethernet services" ("Ethernet 1") and the "Dispute between Cable & Wireless and BT about BT's Ethernet charges" ("Ethernet 2").
3. Verizon broadly welcomes the provisional conclusions that Ofcom reaches in Ethernet 1 and Ethernet 2 (together, the "Drafts"). In particular Verizon considers that Ofcom has taken a clear and consistent approach to determining whether, and if so by how much, BT has overcharged the disputing parties in the Drafts.
4. It is clear that the magnitude and extent of the overcharging is very significant indeed, and is likely to have had a detrimental effect on all of BT's external customers. It is disappointing to say the least that it has necessitated the bringing of disputes for this to be realised and for corrective action to be taken. We would hope that this set of disputes brings into sharp focus the need for BT to properly comply with its cost orientation obligations, and for this compliance to be pro-actively monitored and enforced.
5. We set out some further observations below, which we would ask Ofcom to take fully into account.

### **Applicability to other CPs**

6. On reading the Drafts we were disappointed that Ofcom did not feel the need to make a clear explicit reference to the fact that BT should seek to make repayments to all of its external customers if the provisional conclusions are upheld in the Final Determinations. Ofcom has provisionally concluded that BT has overcharged all of its external customers for the services under consideration, not just the parties involved in these disputes. BT's customers have effectively been coerced into overpaying BT in order to access the relevant wholesale products, with BT reaping the associated benefits.
7. Ofcom, having realised the full extent of the overcharge, should now have an overwhelming preference to put all of the parties who have been overcharged in the position they would have been in had the overcharge not occurred. The reason that

Ofcom should have this preference is because it has a statutory duty to promote competition in accordance with sections 3 and 4 of the Communications Act 2003.

8. We recognise that Ofcom's Final Determinations will be binding only on the parties concerned. However, Ofcom has identified very serious breaches by BT of its SMP obligations as a result of its investigations into Ethernet charging. These breaches have led to all of BT's external customers being overcharged by very large amounts over several years. There can be no doubt that this has had a very harmful effect on competition, and a detrimental impact on the ability of BT's competitors to invest and innovate.
9. Given its statutory duties we would always expect Ofcom to be as pro-active as possible in ensuring that where it identifies anti-competitive practices in a market, it does all it can to rectify the situation for all providers affected. Ofcom should therefore make it very clear in the Final Determinations that it expects BT to make repayments to all customers that have been overcharged, as quickly as possible.

### **Interest**

10. We are very concerned about Ofcom's view on interest in the Drafts and we would urge Ofcom to re-consider its position in this respect for the following reasons.

### Conflict with Ofcom's statutory duties

11. As stated above, in taking account of its statutory duties Ofcom should have an overwhelming preference to put the parties in the position they would have been in had overcharging not taken place. This includes the interest that BT has been able to gain on the amount of each respective overcharge.
12. If BT is simply required to repay the overcharged amounts and is allowed to retain all of the associated interest, then it sets a very worrying precedent which conflicts with Ofcom's statutory duties to promote competition and further the interests of consumers. Not only does it put BT in an unfairly beneficial position, where it has been unjustly enriched, but it does so to the direct detriment of its competitors who lose out on the extra capital they would have had if they had paid cost oriented prices. This means there is less capital available to invest and innovate, and ultimately it is consumers that will lose out.

### Incentives on BT

13. Such a scenario calls into question the type of signal that Ofcom would send to BT if it maintains its view on interest. If BT does not have to pay any interest on overcharges because it has imposed such a contractual term on its customers (see below), it is incentivised to breach its SMP obligations. This is because it is effectively a way for BT to generate working capital on forced loans made to it by its competitors without penalty.
14. From BT's perspective, Ofcom's conclusions in the Drafts represent a favourable outcome in the long run if they were to become binding. It is only required to repay part of the value that it has derived as a result of overcharging its customers. Further, there is no obvious deterrent to behaving in a similar fashion in future if it is able to maintain the current contractual terms. This cannot be the impression that Ofcom wishes to convey to BT.

### Contractual terms

28. In reaching its view on interest, Ofcom puts significant emphasis on the relevant contractual terms in place between the parties. However given the manner in which these terms were imposed on the industry, and BT's refusal to consider revising them, it cannot be fair or reasonable for Ofcom to rely solely on the contractual terms as the basis for its view. This is especially the case when it leads to an outcome in BT's favour.<sup>1</sup>
29. BT has historically refused to consider revising the relevant term on interest in what is an agreement imposed by BT on the industry. It is, in fact, a breach of the requirement to offer fair and reasonable terms and was never accepted by industry. Ofcom may consider that the fairness and reasonableness of the contractual terms is outside the scope of the disputes under consideration.<sup>2</sup> However we would suggest to Ofcom that, first, it is not possible to reach an outcome that is fair or reasonable to the parties involved without considering this; and second,) Ofcom has given itself the flexibility to do so by setting part (iii) of the scope in the Drafts to read "*whether and by how much BT should reimburse the Parties in relation to the overcharge.*"

### Magnitude of harm

15. We would also urge Ofcom to recognise that given the level of the overcharging, the potential level of interest payable is likely to be substantial. This means that if BT were allowed to retain it, the harm caused (and BT's unjust enrichment) would be very material.
16. Therefore the incentive on BT would not just be to overcharge, but to make the overcharge as great as possible in order to generate maximum returns unless and until any repayment is ordered. This would be a perverse and wholly unsatisfactory outcome from the set of disputes before Ofcom.
17. Allowing BT to retain all of the interest that it has generated from all of its external customers is an unacceptable conclusion for Ofcom to reach, for the reasons set out above. While Ofcom may wish to consider and take account of the contractual terms in place between the parties, it should weigh the relative importance of these terms against the other factors that are relevant. We would urgently request that Ofcom reconsider its position on this matter.
18. As we pointed out in our Ethernet dispute submission, Ofcom has considered matters very closely analogous to this in the PPC payment terms dispute, in which it found:

*'Ofcom directs 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>1</sup> We also do not consider that Ofcom should, as it seems to suggest at paragraph 14.37 of Ethernet 1, place any reliance on its current view on interest simply because it is "consistent with [its] previous Determinations".

<sup>2</sup> A point that Ofcom makes at paragraph 7.19 of the Verizon draft Determination on Ethernet charging.

It was also noted in the PPC payment terms dispute that the contract terms "*simply reflect what BT was able to impose on its customers at the time the product was launched by virtue of its significant market power.*" This, of course, is the same in the current case.

### **DSAC cost standard**

19. We note that in the Drafts, Ofcom set out at length its view that DSAC is the appropriate cost benchmark to use in assessing whether the relevant charges were cost oriented. While we understand Ofcom's rationale for this view, we do not necessarily agree with it. Indeed we take the opportunity to register our view that other cost standards, in particular FAC, also have merit in such assessments.
20. Verizon conducted its initial discussions with BT on the basis of overcharging based on FAC, and we consider that it is not necessarily the case that FAC should be consigned to a "second order" or "cross check" status by default.
21. We would caution Ofcom that it is not necessarily the case that one particular cost standard is the most appropriate first order test to employ for every instance of possible overcharging; the consistency that the same cost standard brings must be weighed against the need to ensure the outcome is fair and appropriate in each case.
22. In short, Verizon considers that Ofcom should give very serious consideration to using FAC instead of (as it proposes) DSAC.

### **Compliance, monitoring and enforcement of BT's regulatory obligations**

23. We take this opportunity to raise a general concern about BT's compliance with its SMP obligations, plus the monitoring and enforcement of those obligations.
24. It has become apparent that BT has, for a number of products and services, failed to ensure that it is complying with its cost orientation obligations. Given Ofcom's view on the magnitude and duration of some of the overcharging, BT is a very long way from being compliant and has been for a considerable period of time.
25. These factors give rise to a general concern about how far this non-compliance extends, where BT is subject to cost orientation obligations. It is also of significant concern that this non-compliance has only properly come to light after formal dispute submissions were lodged.
26. Further, BT's response to the investigations into Ethernet charging has done little to reassure the industry (or, no doubt, Ofcom) that it can demonstrate compliance or that it has a firm grasp of its regulatory accounts. For example it has attempted to submit fresh data for consideration (rightly rejected by Ofcom) and is apparently unable to provide the appropriate level of granular cost data in many instances.
27. It is also apparent that it is very difficult if not impossible for BT's customers to verify whether they are overpaying for those products given the information that is publicly available. Ofcom has made clear that it is not simply a matter of comparing BT's published charges and the relevant cost standards. Regardless of the merits of this more nuanced, less "mechanistic" approach, it provides little certainty to BT's competitors that their prices they are paying are fair and cost-oriented, and should not be subject to challenge.

28. Further, even where a customer is able to establish that prices are not cost-oriented, it is not necessarily the case that Ofcom will take the same view on whether an overcharge occurred. Indeed Ofcom is at pains to point out that in such a scenario it will not adopt a mechanistic approach to calculating any overcharge, but rather it will consider a number of other factors, for example the duration of any identified overcharging.
29. It is worth highlighting that, in Ofcom's Draft Determination of the Dispute regarding BT's charges for PPCs, with regard to 140/155Mbit/s PPC terminating segment main link services, Ofcom found that DSAC was exceeded in only one year (2006/07). However, Ofcom still concluded that overcharging had occurred. Such a finding is entirely justified given the scale by which BT's charges exceeded DSAC (74%) and the resultant excessive ROCE of 118% for that year.
30. Whilst the duration of charges above DSAC is a valid factor to be taken into account by Ofcom, it is far from the sole factor that should be considered in determining whether overcharging has occurred. For example, the magnitude of the excess should be sufficient in any given case to justify a finding of overcharging. Were this not to be the case then BT could construe this as an invitation to game the market on a cyclical basis, ie it could overcharge extensively in one year and then price below DSAC in the next few, in the hope that this would not meet Ofcom's "duration" test.
31. For these reasons, it is our firm view that Ofcom should consider taking a pro-active approach to avoid further disputes and investigate other markets where BT is subject to cost orientation obligations.

## **Verizon Business**

**20 April 2012**