



**Excess Construction Charges for Openreach Ethernet Access
Direct**

Proposed Directions in relation to the Leased Lines Charge Control

TalkTalk response

Non-confidential version

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- 1.1 This paper responds to Ofcom's consultation regarding modifying the charging structure for EAD circuits so that rather than the excess construction charge (ECC) being bespoke to each circuit a 'flat rate ECC' charge is levied.
- 1.2 The proposal is that in cases where the estimated ECC on a circuit would be less than £2,800 then rather than a bespoke ECC being charged (i.e. that the ECC charge reflects the projected excess construction costs for that circuit) a 'flat rate ECC' charge will be levied on all these circuits irrespective of the actual level of excess construction cost. This means that the charge for some circuits will be higher than under the previous approach and for some will be lower.
- 1.3 TalkTalk broadly agree with Ofcom's proposals. However, Ofcom must be aware that the change will definitely result in some degree of consumer harm as a result of inefficiencies and competitive distortions. There are some simple steps that Ofcom could take to minimise these (though it cannot avoid all the harm that this change will cause).
- 1.4 The reason we agree with the change is that it will result in a number of operational benefits (for circuit orders where the estimated is less than £2,800):
- it will be simpler for customers, provide more certainty and result in fewer (inefficient) cancellations¹
 - it will reduce lead times
 - it will reduce order handling costs for all parties
- 1.5 However, the change will lead to a large degree of price averaging meaning that prices become *less* reflective of costs. This will result in inefficiencies and distortions and is susceptible to gaming. The key issues are outlined below.
- 1.6 Allocative inefficiency as a result of both excess demand (in the cases of customers with high excess construction costs not facing the full excess construction cost) and suppressed demand (in the case of customers with no/low excess construction costs being deterred from purchasing since they are paying more than their own costs). Effectively the pricing will create cross-subsidies between different customers².
- 1.7 Competitive distortion between Openreach's external customers and other network based competitors such as Virgin and COLT. Whilst Openreach's external customers face the flat ECC wholesale charge, Virgin and COLT who operate their own networks face the (incremental) costs incurred. This means, there will be a distortion between Openreach's external customers and Virgin and COLT. One consequence of this might be, for instance, that Virgin and COLT gain an artificially high share of customers with no/low excess construction costs. It might mean that over time Openreach (and its customers) gain a relatively high share of customers with high

¹ Though some cancellation will be beneficial and improve efficiency. For instance, if a customer cancelled since the ECC was higher than the value they placed on the circuit such a cancellation is a good thing. Ofcom is wrong at §4.9 to suggest that all cancellations are bad

² There will be cross-subsidies if, for some customers, the price is above standalone cost and for others the price is below incremental cost

excess construction costs which will increase the flat ECC. In effect there will be arbitrage between different networks, caused by price averaging.

- 1.8 Competitive distortion between Openreach's external customers and BT's downstream activities. BT's downstream activities do not face (or pay) wholesale charges. Instead they face the (incremental) costs incurred since BT is vertically integrated. Ofcom is incorrect when it says (at §4.22) that "*BT's internal operations would also be subject to Equivalence of Inputs (EOI) obligations which mean that they would also pay the same price as CPs*". Self-evidently, BT's downstream activities do not pay the wholesale charge – the wholesale charge is merely a notional internal transfer that does not affect BT's economic interests in setting prices. Rather BT's economic interest will be based on the underlying costs they incur irrespective of the wholesale charge. Therefore, there will be a distortion between Openreach's external customers (who face the flat ECC wholesale charge) and BT's downstream activities (who face the actual cost of excess construction). In effect, the pricing structure will discriminate in favour of BT's downstream activities in serving customers with no/low excess construction costs.
- 1.9 Potential discrimination against Openreach's external wholesale customers if, for example, these customers have a high share of customers with no/low excess construction costs. If this is the case, then the change in charging structure will mean that wholesale customers will pay a higher aggregate charge for the same circuits. The change would therefore discriminate and be anti-competitive.
- 1.10 Another concern is that BT may have gamed the data used to set the flat ECC so that (all else equal) its external revenue and profit under the new charging structure will increase. BT have shown in the past that they have no compunction in providing selective or biased data to meet their own commercial objectives. We have not had sight of the data provided to Ofcom but we would encourage Ofcom to cast a sceptical eye over what is provided.
- 1.11 Another form of gaming that BT might engage in [§<]
- 1.12 We suggest a number of simple steps that Ofcom could take to address potential sources of harm and risks set out above.
- Checking whether the existing average ECC for external customers' is not less than that for BT downstream activities
 - [§<]
 - Monitoring whether there is 'adverse selection' occurring where Openreach is getting an increasing share of customers who have high excess construction costs compared to Virgin and COLT
 - Minimising competitive distortion between BT's downstream activities and Openreach's external customers by ensuring that BT's downstream / retail prices reflect the Openreach charging structure. Therefore, Ofcom should make clear its expectation that BT's downstream prices mirror the

Openreach charges (i.e. that the prices levied are the same irrespective of actual excess construction cost³)

³ except in cases where the ECC would be over £2,800