Fixed access market reviews: Further consultation on notification periods, compliance with requirements on the VULA margin, and approach to pricing for TRCs and SFIs

TalkTalk response regarding TRC / SFIs

Non-confidential version

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1 Summary

1.1 TalkTalk fully supports Ofcom's proposal to impose a charge control (at FAC) on TRCs and SFIs. We believe that the case for doing so is overwhelming, given BT's excessive charges for these services, which we and other downstream CPs have no choice but to use.

1.2 While agreeing with the principle that there should be FAC-based price regulation of TRCs and SFIs, we believe that the prices currently proposed by Ofcom remains some way in excess of efficient costs. We have in this paper conducted analysis benchmarking the costs per visit which we pay to our subcontracted engineers (Qube) against BT's charges. This demonstrates that BT's price would need to fall by [✂] to bring their 2013/14 prices into line with their costs.

1.3 There are various other benchmarks that could be used to estimate the appropriate price reduction, two of which provide reductions of 37% and 42%. Ofcom has said that the RFS shows that revenues were *significantly* in excess of FAC. In light of these and the Qube benchmark we believe an appropriate price cut would be around [30-40%]. Ofcom's proposal for a 16% price reduction is not justifiable. We also believe that there should be an annual nominal terms price change, of between 0% and –2%, applied to reflect BT's potential efficiency gains.

1.4 We also strongly support Ofcom's proposal to implement the price caps as a one-off price cut at the start of the regulatory period, rather than introducing them via a glide-path. Glide-paths are particularly appropriate where charge controls are currently applied since they allow the regulated firm to retain cost reductions for longer, and so provide high-powered incentives to improve productive efficiency. However, this mechanism is not relevant in the case of SFIs/TRCs since the prices are not currently part of a charge control. The price reductions for SFIs and TRCs are needed not because BT has become more efficient, but because BT has been pricing excessively. In such circumstances, it is appropriate to cut prices immediately, to remove BT's unmerited monopoly profits.

1.5 The remainder of this paper provides TalkTalk's detailed views on Ofcom's proposals.

2 It is appropriate to impose a charge control

2.1 We think that the case for imposing stringent price regulation to constrain excessive prices is very strong. Since these TRCs and SFIs are for the most part not contestable there is the potential for BT to set excessive prices; in practice it has chosen to do so. As Ofcom rightly highlights, the lack of contestability arises since in general TalkTalk is aware when there is a fault that it lies in BT's network, and therefore it has to use a TRC/ SFI to resolve the issue. TalkTalk for its retail customers always uses its own (Qube) engineers when it is sure that they can repair the fault and therefore, by definition, all SFIs TalkTalk requests from Openreach have to be provided by Openreach. Given BT's excessive pricing, we only use Openreach engineers when there is no alternative.

2.2 In fact BT itself seems to think that prices are not constrained since, as Ofcom notes, they said themselves in an internal paper: "*demand for TRC repairs and provision is relatively inelastic, as work can only be done by Openreach engineers*"[1].

2.3 A charge control is preferable to a cost orientation obligation[2] for several reasons.

- It promotes productive efficiency (i.e. cost minimisation) incentives in terms of reducing both unit costs and the time required for each visit/task.
- It cannot be gamed by BT – under a cost orientation obligation BT could (re)allocate costs to TRC/SFI in order to double-recover costs and therefore inflate prices.[3]
- It will ensure more stable prices since the actual costs (and so allowed prices) might fluctuate year to year as, for instance, BT changes the allocation rules used to derive costs.
- It is consistent with the approach to other services.

2.4 We also note that the lack of reliable cost data should not be used as a reason not to impose price regulation or to impose a price reduction that errs on the low side. Using this rationale creates a moral hazard, whereby BT could avoid appropriate price regulation by providing poor cost information.

2.5 A safeguard cap will not prevent excessive prices unless prices are already aligned with costs (which they are not).

2.6 We agree that the charge control should be based on FAC costs (i.e. LRIC plus an allocation of common costs)[4]. Given that BT's marginal return on investment for these services will (by using FAC) be well above its cost of capital Openreach will have a strong incentive to provide these services, and invest as necessary in engineering capacity. We do not consider that using FAC (rather than, say, FAC plus an additional margin) will increase the incentive on BT to diminish quality – BT already has incentives to decrease quality, and has in fact done so in recent years but pricing at FAC will not worsen this incentive. The appropriate response to the risk of diminishing quality is not to allow BT excess returns but rather to directly regulate the level of quality, as Ofcom is proposing by setting minimum service standards.

2.7 We agree with a P0 ('P nought') adjustment i.e. reducing prices to the estimated cost in 2014/15 and then indexing them thereafter rather than using a glidepath to only reach an appropriate level in the last year of the charge control. We explain our reasoning below.

- Aligning prices with costs improves allocative efficiency

[1] See Consultation Jan 2014 §5.33 bullet 2

[2] Also known as a 'basis of charges' obligation. This requires that BT's costs are below a measure of actually incurred costs (e.g. DSAC or FAC)

[3] Through BT's control of the RFS. We note that although Ofcom is proposing in the RFS Review to limit BT's ability to reallocate costs between products, BT is likely to retain this ability for at least a substantial proportion of the forthcoming regulatory period.

[4] Using FAC ensures that costs are only recovered / allocated once

- The reason for the use of a glidepath (and not P0 adjustments) in charge controls is to increase cost minimisation incentive properties of that charge control (by allowing BT to retain more of the benefit of cost reductions). However, this is not relevant for TRCs/ SFIs since the products are currently not charge controlled, and regulatory price reductions do not reflect increased BT efficiency, but the removal of BT's ability to set excessive prices.
- A P0 cut was chosen when Ethernet services were charge controlled for the first time[5], so there is strong regulatory precedent for adopting this approach in the case of SFI/TRC.
- It is simply not credible for BT to argue that a glidepath should be used to avoid 'disruption' since that is effectively suggesting that excessive prices should continue with no economic benefit and BT had a legitimate expectation that excessive prices would continue. The only 'disruption' which would occur with a P0 cut is to BT's flow of monopoly profits; there is no downside risk to any other stakeholder.

3 Appropriate price reduction

3.1 In order to set a charge control (including the P0 adjustment) Ofcom needs to understand BT's costs. The starting point for BT's costs is BT's RFS. However, as Ofcom have described at §§5.64-5.70, these figures are unreliable with significant and unexplained volatility over the past few years. Such poor data is shocking given BT's general regulatory accounting obligations and cost orientation obligations which require BT to provide revenue and cost for products such as TRCs and SFIs[6]. Ofcom should consider (and possibly investigate) whether BT has complied with its various obligations.

3.2 Ofcom has presented two estimates for the price reduction that would be required to bring prices into line with cost. As we understand it they are:

- 'Method 1': the price of an additional hour (at standard times) is £57 (for 2012/13). It has estimated from management data (not the RFS) that the basic cost per hour of an engineer is £50[7]. This implies that the price would need to reduce by 12% to align with the cost.
- 'Method 2': compares the average hourly cost to the average revenue per billed TRC hour. Ofcom says that prices would need to reduce by 40% to bring them into line with costs. This figure has the benefit of being for all worked hours rather than just standard hours (e.g. Monday to Friday 9-5).

[5] Leased Lines Charge Control 2 July 2009 §5.90
http://stakeholders.ofcom.org.uk/binaries/consultations/llcc/statement/llccstatement.pdf
[6] A cost orientation obligations requires that 'each and every charge' is set below DSAC costs thus implying that BT should have revenue and cost data for each and every product
[7] Ofcom do not state this figure but it can be implied since the cost is 12% less than the price of £57

3.3 Ofcom says that this provides a range of 12% to 40% for the reduction in price. It then suggests at §5.90 that it chose a 16% reduction in prices from this range. This is not quite correct.

3.4 The reduction that Ofcom is applying is a reduction to 2013/14 prices. Thus the relevant figures are the reduction in costs to bring 2013/14 prices in line with costs. These are for each method as follows:

- Method 1: the 2013/14 price is £60. Assuming the £50 cost figure is suitable for 2013/14 the required reduction is therefore 16% (as Ofcom notes at §5.89)
- Method 2: TRC prices went up by about 4% from 2012/13 to 2013/14 and therefore assuming the cost remained the same the price reduction required to bring prices into line with costs is 42%

3.5 The range from the two methods is 16% to 42%. Ofcom selected 16%.

3.6 Therefore Ofcom has in practice only used Method 1 – it has not placed any weight on Method 2 and has chosen the figure at one end of the range.

3.7 However, Method 1 requires another correction. Method 1 is based on comparing the headline price (£60) per hour to the cost (£50) per hour. However, the price does not reflect the actual revenue that BT enjoys from the actual work since the full hourly charge is levied for part hours. For instance, if the engineer spends 30 additional minutes on a job a full hour's charge is levied. Therefore, for an hour worked the revenue will be greater than £60.

3.8 The amount of 'excess' will depend on the distribution of job time. Using an average job length of 60 minutes and a normal distribution[8] the average charge per average job would be about £90 (excess of 50%). [✂]. Thus method 1 can be recalculated to correct for this:

- average revenue per hour worked £90 = £60 + 50%
- cost per hour worked £50
- price reduction to come in line with cost is therefore 44%

3.9 We consider that Ofcom should also consider two other methods for deriving BT's costs.

- Industry benchmarking – using the cost of similar field engineers in different companies. This is particularly useful because if the company operates in a competitive market this cost will likely represent an efficient cost level, which is the basis upon which charges should be set.

[8] Based on a normal distribution with an average of 60 minutes and a standard deviation of 60 minutes. The distribution is truncated at 0 minutes since jobs cannot be of negative length. This distribution was considered more representative than a Poisson or Gamma distribution which had very few short jobs.

- RFS data. Though there has been volatility it seems that the 2012/13 data is more reliable than other RFS data. Using RFS data has the key benefit of avoiding double recovery (or under-recovery) of costs from different products since costs are only allocated once. We understand that the data for 2012/13 is based (like other base year data used) on the RFS13 for total costs but using the 2011/12 allocation methods.

3.10 We discuss each of these alternatives below.

3.11 TalkTalk use Qube engineers to provide various in-home installation and repair services to TalkTalk customers e.g. set up of broadband, TV etc. They are similarly skilled to BT engineers (indeed many are ex-BT engineers) and have similar 'overheads' e.g. van, equipment etc. [✂]

- [✂]
- [✂]
- [✂][9].

3.12 [✂]. We can estimate the price reduction for prices to reach the Qube cost as follows:

- BT in 2013/14 charges £60 (Monday – Friday normal working hours), £90 (Saturday and weekday evenings);
- assuming (conservatively) a 90%, 10%, mix this gives an average price of £63;
- An effective increase in price (due to charging by the hour) of 50% gives an average BT price of £95;
- Thus the required price reduction for prices to reflect costs is [✂]

3.13 The RFS provide a figure for revenue and FAC cost. At §5.73 it says that "*revenues were significantly in excess of FAC*". The figure is redacted – [✂]. Whilst it appears that the RFS data is not ideal it seems that the 2012/13 data is more reliable than other years (e.g. 2012/13 corrected a "*previous misallocation of costs*" (§5.65))[10]. There is an important benefit from using the RFS over management data (as in Methods 1 and 2) in that it will not involve any double recovery of costs, since in a single instance of the RFS common costs are only recovered once.[11] This is not necessarily true of management cost data. Therefore if the costs based on management data are higher than the costs in the RFS it may be because costs that have (say) been allocated in the RFS to AISBO are allocated to SFI/TRC in management data.

[9] [✂]

[10] We note that BT argues (§5.66) that there needs to be adjustments to increase the costs of SFI/TRC. However, these appear ploys to double recover costs by shifting costs already recovered in e.g. AISBO and TISBO charges onto SFI/TRC

[11] They may be double-recovered due to BT amending cost allocations after a charge control has been set for a particular group of products.

3.14 Thus there are four data points that could be used for the reduction in 2013/14 prices needed to reduce prices to cost:

- 37% – Method 1: based on management data for standard hours
- 42% – Method 2: based on management data for all hours
- [✂] – based on TalkTalk's estimates of the costs allocated in the RFS (for 2012/13)
- [✂] – based on benchmarking against Qube

3.15 Of all the data we consider that the Qube costs are the most relevant and reliable – they are based on the efficient cost and the estimate is a reliable figure is observable and is what is actually paid, rather than a partially subjective estimate made using BT's internal accounting data. We also think that the RFS data has an important benefit of ensuring that cost are not double recovered. However, all of the methods other than the Qube comparison face the problem that they reflect BT's actual cost level, rather than the efficient cost level.

3.16 Even if a straightforward average of the above four methods were used– implicitly, treating all of them as if they had equal weight, rather than considering the Qube comparator to be a better method than the others– this would lead to a price reduction of [✂]. We consider that Ofcom should introduce a P0 cut for TRCs and SFIs of [30-40%]. This would bring BT's pricing much closer to (but still above) an efficient level, while remaining within the range specified by Ofcom. This approach would also provide an impetus for BT to review its organisation of work to search for possible efficiency gains since efficiency incentives are strongest if prices are set based on exogenous benchmarks rather than, say, by reference to BT's own costs.

3.17 We strongly urge Ofcom to reconsider its view of the appropriate price reduction to align prices with costs since alternative– and more reliable– evidence is available to the single data point it used[12]. Further, if Ofcom were to err on the side of a low reduction (since it might see this as the cautious approach) it will effectively be rewarding BT for providing unreliable and incorrect data (and for breaching its regulatory obligations). This would create moral hazard. Using the low end figure as proposed by Ofcom awards BT the 'benefit of the doubt'. In the circumstances this is wholly inappropriate.

4 Changes in costs / indexation

4.1 Ofcom has assumed that BT's costs will change by between -0.1% and +2.8% a year. The 2.8% figure implicitly assumes that all costs are labour costs and so it not appropriate in any event. The -0.1% figure is derived (according to §5.112) as follows:

[12] We note that Ofcom has implicitly assumed that the level of price reduction required to align prices and costs is the same for all TRC and SFI services. This is reasonable assumption given the lack of robust data – however, it might not be true.

- Labour based costs will increase at the wage inflation rate (currently assumed to be 2.8%)
- Non-salary costs will reduce by the efficiency rate – 6% (upper bound)

4.2 We do not think this approach is correct since Ofcom has implicitly assumed that labour costs are immune from any efficiency gains, whereas in general there will be scope to make labour efficiencies (for example, through substitution of technology for labour, changing labour skillsets, or reducing task times). The approach to cost estimation should be consistent with that used in the LLU Charge Control[13]. We see no reason (with one small exception as set out below) to adopt a different approach to cost forecasting for SFI/TRC versus other LLU/WLR products. The approach should be (figures are those proposed by Ofcom):

- pay inflation at 2.8%;
- non-pay inflation at 3%;
- efficiency gains of 5% (range 4% to 6%);
- an adjustment for volume – in this case zero since the costs are mostly variable and volume changes are unlikely to be significant.

4.3 We do not consider that Ofcom's inflation and efficiency assumptions are appropriate (we have commented on this in our October 2013 submission). However, for the purposes of illustration we used Ofcom's proposals.

4.4 There is one justified departure from this approach, which would be that where a product is charged on a 'per hour' basis then the full efficiency gain should not apply. Efficiency gains come from two sources:

- reducing the time required to carry out particular tasks (e.g. fixing a particular fault, making a visit to fix a particular fault)
- reducing the cost per hour of task (e.g. less qualified / less expensive staff, less travel and unproductive time, lower management overhead).

4.5 In the case of a product charged on a per hour basis the costs will not reduce as the task time reduces, although the costs per hour may still fall.

4.6 Therefore the changes in costs should be estimated as follows – in this case we assume that 2% of the efficiency gain is due to a reduction in task times (and 3% reduction in cost per hour):

Category	Products priced per task	Products priced per hour
Pay inflation (A)	2.8%	2.8%
Non-pay inflation (B)	3.0%	3.0%

[13] For the avoidance of doubt we consider the inflation rates Ofcom uses are too high. It is the principle of being consistent that we advocate here

Efficiency (C)	5.0%	3.0%
Overall[14]	– 2%	+ 0%

4.7 We do not know the mix of products priced per hour and products priced per task but SFI services are all priced per module (i.e. per task) and the majority of TRCs will be priced per task (since all TRCs will involve a visit charge but only some will involve an additional hourly charge). Therefore we imagine that if a single cost index is required it is probably around – 1.5%.

4.8 Based on this we see two options for Ofcom setting the indexation

- Either set the same indexation for all products at – 1.5%
- Or,
  - set the indexation for products priced per task at – 2%
  - set the indexation for products priced per hour at +0%

4.9 These same cost change figures should be used for calculating the cost change between 2012/13 and 2013/14. For example, the cost in 2013/14 should be the 2012/13 figure indexed forward at the appropriate rate.

5 SFI charges

5.1 Ofcom has not proposed a specific reduction in SFI charges. Rather it has required that BT should base its SFI charges on the same £50 hourly cost that is assumed for TRC and use its revised estimates for the time taken for each SFI module to calculate the price for each SFI module. Whilst being consistent with the approach to TRC is sensible, Ofcom's approach allows BT with a clear opportunity to game the system by exaggerating the time taken for each SFI. Ofcom has recognised that gaming is possible but considers that this can be protected against. Ofcom says (at §5.107):

> *While we are setting the maximum hourly (and visit) rate in an SFI module, BT will have discretion over the average module duration that ultimately informs the module price (in recognition that this may reasonably change over the review period). We accept this approach potentially gives BT a high degree of flexibility over SFI prices (due to the link with the time typically taken to complete each module), and so we also propose to maintain the requirement for fair and reasonable charges on SFIs, to protect against potentially anti-competitive or abusive use of this flexibility (e.g. we would expect BT, if required, to be able to justify any changes to the durations used in the SFI price calculations).*

5.2 We do not think this approach is appropriate for several reasons:

- It will eradicate BT's incentive to become more efficient by reducing task times, since if it reduces task times the price reduces, thereby meaning that increasing efficiency will not increase profits – in essence this is a partial form of 'rate of return' regulation (where prices are based on actual costs). It

[14] Overall = A x % costs pay + B x % costs non-pay – C. We estimate that non-wage is 20% of the total

is broadly accepted that rate of return regulation leads to worse outcomes for cost reductions and efficiency than price cap regulation.

- BT could effectively increase its prices and profits by using less qualified or less experienced staff who cost less but take longer – the increased task time will be factored into increased prices but the lower cost staff will not be.
- BT has shown previously that it has absolutely no compunction in manipulating data to meet its own self-serving commercial interests. It could for instance, calculate the data in a different way that increases the time per task; CPs and even Ofcom would have little ability to challenge the data.
- The fair and reasonable obligation is no effective constraint on BT's behaviour:
  - CPs lack the data to be able to challenge BT's claims regarding the time required for different modules. Ofcom's proposals for cost accounting data (at §5.137) are vague and unspecific and it is certainly far from certain that the data will either be available, or be reliable enough, for CPs to mount a challenge.
  - When the fair and reasonable obligation was used to resolve a dispute regarding the level of service level guarantees (SLGs), Ofcom concluded that Ofcom's role was to decide the SLG offered by Openreach was within a wide range of plausible SLGs[15]. This thereby gave BT wide discretion regarding the method and assumptions used to set an SLG. If the same framework was used to resolve a dispute regarding the time period it is likely that this would give BT flexibility to inflate the required time.
  - The dispute resolution approach will absorb a large amount of Ofcom's and stakeholders' time compared to the quantum of resource required to resolve this same issue within the market review / charge control process.
  - Bringing a case to dispute will take months, during which BT will be able to overcharge CPs.
- It is, in our view, fundamentally unfair and wrong to award BT discretion when the problem of unreliable data is of BT's making. As in other areas, customers should not bear the costs of BT's inefficient management.

5.3 Ofcom's proposed approach is also inconsistent with the approach it takes elsewhere in the LLU charge control – for instance, for normal fault repair (the cost of which is included in rental charges) Ofcom sets a cost projection reflecting task time and cost per hour. It does not allow BT to adjust the MPF price upwards if the task times increase.

[15] §§44.18 – 4.24 Dispute between TalkTalk Telecom Group PLC and Openreach relating to whether Openreach offered MPF New Provide to TalkTalk on fair and reasonable terms and conditions 15 August 2013

5.4 We therefore strongly disagree with Ofcom's proposed approach for SFI prices. Instead we suggest that Ofcom requires that SFI module prices reduce at the same rate as TRC (i.e. 16% and subsequent indexation).

6 Other issues

6.1 Finally, we raise a number of other issues.

6.2 [✂].

6.3 It is clear from Ofcom's consultation document (and our comments above) that setting this charge control has been hampered by BT's poor data, despite clear regulatory obligations to provide sound RFS (covering TRC/SFI) and also to publish the costs of each and every TRC/SFI product that flows from the cost orientation / the basis of charges obligation. Ofcom must ensure that BT is able to provide far more robust cost data for SFI and TRC for the next charge control.