

# **Implications of SJ-MPF Dispute Determination**

TalkTalk comments

Non-confidential version

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### 1 Introduction

- 1.1 MPF has been, and remains, engineered using an approach known as double jumpering (referred to in this document as **DJ-MPF**) which uses two jumpers<sup>1</sup>. An alternative option exists which uses a single jumper (referred to as **SJ-MPF**). Single jumpering has the potential to save significant costs of over £100 million although there are some costs that would be incurred to realise this saving. Any net cost saving would deliver significant consumer benefits through lower retail prices, more extensive competition (i.e. through greater unbundling of exchanges) and more effective competition due to a more level playing field.
- 1.2 The possibility of SJ-MPF has been known about / discussed for over 7 years:
  - BT used a single jumper arrangement for deploying its 21CN network starting in 2005/2006<sup>2</sup>
  - Using single jumpering for MPF was first suggested by Openreach to CPs in  $2007^3$
  - In 2009 TalkTalk suggested that MPF charges should be based on single jumpering (as this was a lower cost way of providing MPF services). Ofcom considered that it was not clear whether this was the case and decided to base MPF prices on costs using double jumpering<sup>4</sup>
  - Following Ofcom's decision (and the subsequent appeal), in 2010 TalkTalk submitted an Statement of Requirements<sup>5</sup> ("SOR") for a SJ-MPF product to Openreach. Openreach rejected the SOR with limited explanation
  - Following the rejection of the SOR, Ofcom reviewed single jumpering in the LLU charge control consultation during 2011 and 2012. It concluded that it was not clear whether single jumpering was more efficient and that the development of a SJ-MPF product should be considered through the OTA and SOR process
  - Following Ofcom's decision, in 2012 TalkTalk submitted another SOR for a SJ-MPF product to Openreach which was also rejected
  - In 2013 TalkTalk submitted a dispute to Ofcom to determine whether Openreach should provide a SJ-MPF product

<sup>&</sup>lt;sup>1</sup> A jumper is a copper wire from one side the main distribution frame (MDF) to the other

<sup>&</sup>lt;sup>2</sup> 2012 LLU Charge Control §A9.3 (bullet 3)

<sup>&</sup>lt;sup>3</sup> 2012 LLU Charge Control §A9.3 (bullet 3)

<sup>&</sup>lt;sup>4</sup> This decision was appealed by CPW (predecessor of TalkTalk) and the Competition Commission concluded that supported Ofcom's decision e.g. §3.127 WLR Determination "We consider that the position that Ofcom took in the decision in relation to single jumpering was reasonable given the absence of an SOR and therefore a feasibility study or other evidence that single jumpering would be a more efficient method of wiring MPF"

<sup>&</sup>lt;sup>5</sup> This is effectively a request to Openreach to develop a new product or modify an existing product

- 1.3 The final determination of that dispute ("SJ-MPF FD") was published on 15 November 2013. This determination concluded that Openreach need not develop a SJ-MPF product (in future) principally because it would not result in net cost savings (i.e. it was not more efficient than DJ-MPF). This paper discusses a number of implications of that decision.
- 1.4 The <u>first</u> implication is that the LLU Charge Control should use the same incremental frame cost assumption as was used in the SJ-MPF FD.
- 1.5 The <u>second</u> issue results from the fact that if SJ-MPF had been launched in 2007 (when Openreach first reviewed SJ-MPF) it would have delivered significant cost savings (later launches would also have generated significant, though lower, cost savings). This raises the question of whether SJ-MPF should be considered as the efficient approach for providing MPF services and therefore whether MPF charges should be set on the basis that SJ-MPF is used.
- 1.6 The <u>third</u> issue addresses the point that Openreach has, through obfuscation and delay, been able to delay the development of SJ-MPF to the degree that it is no longer viable and in doing so has harmed consumers' interests (however, such delay has been squarely in BT's commercial interests). In our view it is worth considering whether the regulatory framework around product developments could be improved to avoid or discourage such harmful behaviour in future.

### 2 Assumption for frame cost

- 2.1 The key cost saving from moving to SJ-MPF is the reduced main distribution frame ("**MDF**") cost. The size (and cost) of an MDF depends on the number of jumpers it can support and so if fewer jumpers are required (as a result of SJ-MPF) the MDF cost is reduced. We refer to this cost as the 'frame cost'.
- 2.2 In conducting its assessment of cost savings Ofcom (rightly) focussed on incremental costs:

"... the most relevant cost concept should be based on a <u>long-run forward-looking view of</u> <u>the relevant incremental costs</u>." [SJ-MPF FD §3.17]

2.3 One measure of incremental cost is the LRIC<sup>6</sup> estimates in BT's regulatory accounts ("**RFS**"). In this case regarding SJ-MPF, Ofcom considered that the LRIC figures overestimated the cost saving that would result from one fewer jumper since Ofcom judged that only part of the total LRIC cost was genuinely variable.

"... for the purpose of resolving this Dispute we are interested in the cost savings from reducing activities on frames, not stopping them entirely" (§4.118).

"However the increment on which these calculations [of LRIC] are based is demand for the whole component and therefore may not be a good measure of how costs might vary as the numbers of jumpers installed changes." (§A3.193)

<sup>&</sup>lt;sup>6</sup> LRIC – long run incremental cost

2.4 In particular, Ofcom concluded that much of the LRIC cost figure was not incremental with respect to the number of jumpers:

"We think it unlikely that the cost of the ironwork, ladders or physical infrastructure on which the frame blocks rest would vary materially if the number of jumpers changed." (§4.114)

"[that frames capital includes software depreciation] provides some support for our assumption that the relevant incremental CAPEX may be limited and restricted to frame blocks" (§4.121)

*"We consider it unlikely that accommodation costs would change as a result of increasing or reducing the number of jumpers within an exchange." (§4.122)* 

"Our conclusion from the above is that the only significant incremental cost saving in CAPEX is likely to come from expenditure on frame blocks" (§4.123)

- <sup>2.5</sup> The result of this is that Ofcom estimated the incremental saving per jumper at  $\pm 1.10^7$  per year (operating and capital). This is much less than the LRIC of about  $\pm 2.90^8$  that is detailed in the RFS.
- 2.6 In the current LLU/WLR Charge Control Ofcom has also grappled with the frame cost resulting from more or fewer jumpers. In that case, it is because Ofcom wishes to set the WLR rental and MPF rental price difference to equal the incremental cost difference in order to promote productive efficiency. One key cost difference between an MPF line and a WLR line is that an MPF line involves one more jumper resulting in more use of the frame<sup>9</sup>. Ofcom said regarding the use of incremental cost (§3.65):

We explained that we considered [setting WLR rental and MPF rental price differences to equal their incremental cost differences] to be appropriate because these services are substitutes which can be used to provide downstream voice and/or broadband services. We consider that where wholesale services are substitutes, <u>price differentials should ideally be</u> <u>equal to incremental cost differences</u> so that purchasers are given incentives to use the service which minimises total costs, and this means that the amount of common costs recovered per line should be the same in each case.

2.7 Thus in the LLU Charge Control, Ofcom was (like in the dispute) intending to identify the <u>incremental</u> frame cost difference resulting from the one additional jumper that is used by MPF (versus WLR). Similarly the relevant increment for assessing the cost of an additional jumper was treated in the charge control and the dispute as *"the cost savings from reducing activities on frames, not stopping them entirely."* 

<sup>&</sup>lt;sup>7</sup> This comprises £1 (base case) for operating costs (see §4.127 and an estimated £0.10 per year on frame blocks. The frame operating cost saving is £1.00 per line per year and results in an NPV saving of £3.6m. The NPV of the block cost saving is £0.4m which implies that the frame block saving is equivalent to an annual cost saving on £0.10. We have expressed the CAPEX costs e.g. blocks as an annualized capital charge (i.e. depreciation, ROCE) for ease of comparison

<sup>&</sup>lt;sup>8</sup> Though Ofcom is not explicit about the LRIC for the frame cost component in the LLU/WLR charge control (it only provides the total LRIC for each of MPF rental and WLR rental) the frame LRIC can estimated since the frame FAC in 2013/14 is £3.13 (Table A2.10) and LRIC as a % of FAC is 90% to 95%

<sup>&</sup>lt;sup>9</sup> other cost differences include WLR uses a line card whereas MPF does not, there are different levels of faults and thus fault repair costs, MPF requires broadband testing equipment where as WLR does not

- 2.8 However, although there should be consistency between the assumption adopted in the two reviews, Ofcom has in fact adopted two very different assumptions:
  - In the case of the SJ-MPF dispute Ofcom has assumed that the incremental frame cost resulting from one fewer jumper is £1.10
  - In the case of the LLU charge control Ofcom has assumed that the incremental frame cost difference resulting from one fewer jumper is £2.90 (from BT's RFS)
- 2.9 What Ofcom has effectively done is that in judging whether there is an incremental saving from one less jumper by using SJ-MPF rather than DJ-MPF it has assumed that there is only a £1.10 saving whereas when it assesses the incremental cost difference between WLR and MPF (WLR requires one less jumper) it has assumed that the cost reduction is £2.90. There is a clear inconsistency between these approaches.
- 2.10 We do not consider that such a difference in assumptions is justified. If Ofcom is right to use £1.10 in the context of the SJ-MPF FD, we consider that the correct assumption is also £1.10 in the LLU charge control.

### 3 Efficient approach for MPF provision

- 3.1 In this section we consider whether MPF charges should be set on the basis of MPF being provided using single jumpering or double jumpering. We discuss:
  - whether an earlier launch of SJ-MPF would have resulted in a new cost saving;
  - the need to set charges based on efficient costs;
  - whether it is appropriate to set MPF charges based on the costs of single jumpering
  - options that could be used to adjust prices.
- 3.1 Impact of earlier SJ-MPF launch
- 3.2 In assessing whether Openreach should offer a SJ-MPF product Ofcom in its SJ-MPF FD (rightly) focussed on whether there was an overall net cost saving. There are a number of cost impacts:
  - Reduction in costs: reduced use of frame, fewer tie cables, lower cost jumper install/removal
  - Increase in costs: product development; lower utilisation of TASM<sup>10</sup>, master controller, test heads and racks
- 3.3 Ofcom's SJ-MPF FD assumed that the SJ-MPF product would start to be developed in January 2014 and would be launched in July 2015 (but not start to be used until

<sup>&</sup>lt;sup>10</sup> Test Access Switch Matrix, a special type of switch that facilitates testing of telephone lines. A TASM is controlled by a master controller and provides multiple line ports, each port serving a single line. When a line needs to be tested, the TASM connects (switches) this line to the appropriate test head

2016/17<sup>11</sup>). Ofcom concluded that on this basis in its 'Medium' case that the net cost saving (in NPV terms) from SJ-MPF was  $-\pounds0.5m$  (i.e. marginally negative<sup>12</sup>). Different scenarios tested by Ofcom yielded NPVs from +£18.0m to  $-\pounds7.4m$ . We think that Ofcom's medium case under-estimates the net cost saving, though for the purposes of this submission we assume that Ofcom's cost saving estimate is sound.

- 3.4 The net cost saving (if any) depends critically on the volume of lines that could be deployed on SJ-MPF. SJ-MPF involves a variety of fixed costs (e.g. product development costs are fixed, the smallest TASM unit handles 200 lines and one is required in each exchange where single jumpering is used). This results in material economies of scale as shown by Ofcom's sensitivity analysis.
- 3.5 Ofcom's assessment of potential net cost savings was based on the assumption that if a SJ-MPF product were launched it would only be used for net additional MPF lines (referred to as an 'expansion-only' approach<sup>13</sup>). This would leave the number of lines on DJ-MPF unchanged and avoid possible stranded assets<sup>14</sup>. This approach means that the later that SJ-MPF is started/launched the fewer lines can be put onto SJ-MPF. The graph below shows how the number of lines put onto SJ-MPF reduces rapidly as the launch date is delayed.



Potential lines on SJ-MPF<sup>15</sup>

 $<sup>^{\</sup>rm 11}$  This is because the DJ-MPF equipment is topped up to full utilisation before lines are deployed on SJ-MPF

<sup>&</sup>lt;sup>12</sup> We say marginal since the negative NPV is small versus the investment which is about £18m. The IRR is also probably about 8% versus a hurdle rate of 8.8%.

<sup>&</sup>lt;sup>13</sup> see SJ-MPF FD §§3.36-3.28 and footnote 286

<sup>&</sup>lt;sup>14</sup> Based on Ofcom's model, after SJ-MPF was launched, the TAMs and tie cables used for DJ-MPF would be 'topped-up' to full utilization before any lines were put on SJ-MPF

<sup>&</sup>lt;sup>15</sup> The graph reflects the actual and potential growth of MPF lines and that only 'expansion' lines would be deployed onto SJ-MPF. In the dispute, although SJ-MPF was assumed to be launched in July 2015 the first new lines are not put onto SJ-MPF until 2016/17

- 3.6 Therefore, it follows that the net cost saving from SJ-MPF is critically dependent on <u>when</u> the SJ-MPF product is assumed to start the later SJ-MPF is started/launched, the fewer lines are put onto SJ-MPF and the lower the net cost saving. This high sensitivity to volumes is clear from Ofcom's own analysis which shows that just a 10% increase in volume increases the value of SJ-MPF from –£0.5m to +£1.1m (a 10% increase sis much less than the volume increases that would result from launching SJ-MPF earlier).
- 3.7 This relationship is shown in the graph<sup>16</sup> below which shows the NPV<sup>17</sup> assuming different start dates. This is illustrative since we do not have Ofcom's working model. However, it is we believe reasonably sound for instance
  - From Ofcom's analysis we know that if SJ-MPF started to be deployed from 2016/17 (as per the dispute) then the NPV is -£0.5m
  - if SJ-MPF was used from 'day one' (so that there was no existing base of DJ-MPF and so no loss of utilisation) then the NPV would be about £100m to £200m<sup>18</sup>
  - in between these two points we know that the NPV is closely linked to volume



Cost saving from SJ-MPF (*illustrative*)

<sup>&</sup>lt;sup>16</sup> based on Ofcom's own model from the SJ-MPF FD. This under-estimates the value from earlier launch since if launch was earlier many MPF lines would be in new exchanges where there was no DJ-MPF estate to use thereby making the benefit of SJ-MPF even higher

<sup>&</sup>lt;sup>17</sup> this is NPV measured at the launch date

<sup>&</sup>lt;sup>18</sup> This is the NPV saving (in 2013) from lower frame costs, fewer tie cables and lower jumper installation/removal costs. The added costs from lower utilisation are not included since if SJ-MPF was used from day one then there would be no lower utilisation. There would be a very minor utilisation penalty (from SJ-MPF versus DJ-MPF) that separate TASMs would be needed for each of Sky and TalkTalk

- 3.8 Thus we get a curve whereby as the start date is delayed the NPV falls rapidly until, with a 2015 launch date (and first line put in SJ-MPF in 2016/17), the value is negative, as too many DJ-MPF lines have been rolled out to enable SJ-MPF savings to cover the fixed costs of launching SJ-MPF.
- 3.9 It is clear (irrespective of particular assumptions) that if SJ-MPF had been introduced in (say) 2007 it would have resulted in a significant positive NPV and net cost saving. Thus it follows that if Openreach had acted efficiently it would have launched SJ-MPF in 2007 (or possibly earlier) and the costs of MPF today would have been lower.

#### 3.2 Prices need to be based on efficient costs

- 3.10 It is well accepted that regulated charges should be based on efficient costs for instance in 2013 LLU/WLR Charge Control §1.12 "charge controls, indexed by inflation, designed to align current charges to forecast efficient costs". The use of efficient costs reflects that in a competitive market operators are only able to pass on efficient costs, and that setting prices at the efficient cost level encourages both productive efficiency and efficient investment. A similar reason was cited for using NGN costs for setting interconnection charges (NGN was a technology that BT had not deployed but was lower cost), in that using NGN costs reflected contestable market principles i.e. what an efficient new entrant would do<sup>19</sup>.
- 3.11 The corollary of this is that charges should not be based on BT's <u>actual</u> costs since if prices are set in this manner it would weaken cost minimisation incentives on BT because cost reductions will be less profitable. Rather, the decision on what is efficient should be based on exogenous evidence, rather than on what BT actually does. This is the approach Ofcom took for setting charges for voice interconnection services<sup>20</sup>. The implication of this is that shareholders bear inefficient costs (which is accepted by BT<sup>21</sup>).

<sup>&</sup>lt;sup>19</sup> see §A5.15 of Review of the fixed narrowband services markets; Statement on the proposed markets, market power determinations and remedies Sept 2013

<sup>&</sup>lt;sup>20</sup> In the case of setting charges for voice interconnection services though BT uses TDM technology to provide these services the prices are set on the basis that BT was using NGN (NGN is referred to as the MEA, modern efficient asset). Ofcom does adopt another approach to selecting the technology on which to base cost which is called the anchor pricing approach. In this case, Ofcom intentionally whereby they use the old/legacy technology to set charges e.g. copper not FTTC. However, the reasons for using anchor based is not relevant here since an anchor based approach is used where the new technology is higher cost and higher capability. In this case the new technology (i.e. single jumpering nor double jumpering) is lower cost

<sup>&</sup>lt;sup>21</sup> For instance from Witness Statement by Felipe Florez-Duncan, Senior Regulatory Economist, BT (in July 2011 WBA Charge Control appeal). "As Professor Yarrow's assessment of the core objectives and principles of RPI–X regulation explains, shareholders should bear the inefficient level of costs that they can be shown to be responsible for …"

#### 3.3 What are efficient costs for MPF provision?

- 3.12 The evidence above indicates that it is more efficient to provide MPF using single jumpering<sup>22</sup> if Openreach had launched SJ-MPF when it was efficient to do so, SJ-MPF would now be widely used and the cost (and price) of MPF would be lower. That Openreach have not implemented SJ-MPF it is not in our view determinative of whether SJ-MPF is more efficient than DJ-MPF.
- 3.13 It should follow from this that MPF prices should be set on the basis that MPF is provided using SJ-MPF.
- 3.14 This is the same approach as was adopted for setting voice interconnection charges (starting in 2014) where Ofcom's cost estimates assumed that BT had begun widespread deployment of NGN technology in 2007/08, even though BT had in fact not done so<sup>23</sup>. This further supports our contention that prices today can and should be based on the assumption that Openreach should have previously deployed a more efficient technology though in fact it chose not to do so.
- 3.15 We think that the condition that needs to be met to base MPF costs on the use is single jumpering is: <u>could Openreach have reasonably known previously that SJ-MPF</u> was more efficient (and if so when)? It would be unreasonable to base the price of a product on an engineering approach that Openreach could never have known was lower cost.
- 3.16 We discuss this issue below.
- 3.17 Firstly, it is worth considering why Openreach might not have implemented SJ-MPF. There are clear *a priori* reasons as to why Openreach would not want to implement SJ-MPF even if it were clearly lower cost:
  - SJ-MPF would relatively disadvantage BT Retail and thus harm BT Group, since only BT's rivals use MPF (in any material volume) and so only rivals would enjoy the cost reduction. This would lead to price cuts to consumers, and BT Retail losing market share and/or margin.
  - Openreach would not enjoy any additional profit resulting from reducing costs from SJ-MPF since the cost saving would (via the charge control mechanism) be passed through to CPs and consumers
- 3.18 As such, the net profit impact on BT Group from introducing SJ-MPF would have been negative.

<sup>&</sup>lt;sup>22</sup> We accept that for some lines DJ-MPF would be more efficient since they would have been installed before SJ-MPF were introduced and it would be lower cost to maintain this volume of lines on DJ-MPF (i.e. the expansion-only approach). However,, for the purposes of this discussion we have assumed for simplicity that all lines would be on single jumpering

<sup>&</sup>lt;sup>23</sup> see §A8.5(iii) and footnote 875 of Review of the fixed narrowband services markets; Statement on the proposed markets, market power determinations and remedies Sept 2013. Previously, in 2010 Ofcom had set the charges based on TDM (not NGN) technology.

- 3.19 We think that BT's incentives have been born out in practice, as Openreach has over many years blocked the development of an SJ-MPF product through obfuscation, lack of transparency and not properly analysing SJ-MPF. We provide examples of this at §4.8.
- 3.20 The existence of these strong incentives to not develop SJ-MPF mean that Ofcom cannot rely on Openreach's actual behaviour as indicative of what Openreach knew or should have known.
- 3.21 We consider that the test should be based on whether Openreach *could reasonably have known* rather than whether they *actually knew*. This is because if charges were based on whether Openreach *actually* knew SJ-MPF was lower cost then this leaves too much opportunity for Openreach to game regulation by, for example, not investigating developments or assigning insufficient or unsuitable staff to investigate developments that are not in its interests. We believe that Openreach is very likely to have engaged in such regulatory gaming when SoRs for SJ-MPF were presented.
- 3.22 Thus the question of whether to set MPF charges based on SJ-MPF costs should in our view turn whether Openreach could have reasonably known<sup>24</sup> that SJ-MPF was lower cost and then whether SJ-MPF could reasonably be implemented and used.
- 3.23 We consider that Openreach could have easily have furnished itself<sup>25</sup> with the necessary information and analysis which would have shown that SJ-MPF was lower cost. It already knew in 2007 the various cost implications of SJ-MPF (and had worked out the situations in which it would be lower cost); the analysis itself was not difficult (given Openreach's expertise); and Openreach had all the necessary data available to it (e.g. number and size of exchanges, MPF forecasts, available TAM capacity, impact of SJ-MPF on equipment volumes, prices of equipment etc).

<sup>&</sup>lt;sup>24</sup> Another similar reason for using the 'could have reasonably known' test is if one considers that Openreach may have made a mistake due to incompetence. If this were allowed as an excuse for not acting efficiently then Openreach would be rewarded for incompetence (and would have an incentive to allocate insufficient/incompetent staff to not investigate developments that are not in its interests). In a competitive market, firms will not be able to recover from their customers additional costs incurred due to managerial incompetence.

<sup>&</sup>lt;sup>25</sup> We note that in the 2009 LLU/WLR Charge Controls (and also in 2012 LLU Charge Control) Ofcom considered whether single jumpering was lower cost and concluded that it was not clear to Ofcom whether SJ-MPF was lower cost or not (see §A5.60 2009 WLR Charge Control, §A9.3 2012 LLU Charge Control). However, this reflects that Ofcom has limited information available to it and so cannot be relied on to assess what Openreach knew.

- 3.24 Furthermore, Openreach had already at that time completed plenty of analysis that demonstrated that single jumpering was lower cost for volume deployment<sup>26</sup>:
  - It planned and then deployed a single jumpering arrangement for its 21CN network which was planned to accommodate millions of lines
  - In 2007 Openreach in fact proposed moving to a single jumpering arrangement for MPF since it said *"the 'as is' architecture is not ideal for a volume MPF world"*. The reasons it gave for this was that DJ-MPF was inefficient, drove up costs and used more resource, materials and labour.<sup>27</sup> Openreach had also correctly identified the scenario where SJ-MPF would be beneficial – large volumes of MPF where little existing TAM capacity was available and using SJ-MPF for expansion only
- 3.25 It has also been suggested that even if Openreach knew SJ-MPF was lower cost, Openreach could not have introduced SJ-MPF since there was not support from CPs and/or CPs did not submit an SOR<sup>28</sup>. This is of limited or no relevance in this case:
  - Openreach did not need an SOR to be submitted or agreed by a CP to be able to develop and launch the product. Openreach makes many product modifications itself which don't have wide CP support or agreement<sup>29</sup>
  - Further, in terms of assessing the cost savings of SJ-MPF or how it should be deployed Openreach did not need input from CPs – Openreach could have easily anticipated the circumstances in which CPs would use SJ-MPF if it were launched
  - If the product were launched and the prices reflected the substantial cost savings (as they should have) then CPs would have consumed the product in significant volumes since it would have delivered over £100 million of cost savings to them<sup>30</sup>. The only reason there wasn't support to use the product was because Openreach stated that they will "continue to use our current Prices to cover both Traditional and [SJ-MPF]" and there would be "no price changes" <sup>31</sup> in MPF charges<sup>32 33</sup>

<sup>&</sup>lt;sup>26</sup> That industry originally agreed in early 2000s that MPF should be engineered using double jumpering (as discussed in LLU Charge Control §A9.54) is irrelevant. DJ-MPF was appropriate for low volumes as originally anticipated but by 2006 it was obvious volumes would be much greater and the SJ-MPF was much lower cost (see §A9.56). It is the very nature of networks that they need to innovate and change.

 <sup>&</sup>lt;sup>27</sup> See slide 2 Openreach presentation LLU TAM – Selective 'In-Line' Deployment 23 July 2007
<sup>28</sup> See 2012 LLU Charge Control §9.53

<sup>&</sup>lt;sup>29</sup> In any case, if Openreach had proposed the SJ-MPF product and the SJ-MPF prices reflected the substantial cost savings (as they should have) CPs would have 'bitten off Openreach's hand' to support Openreach

<sup>&</sup>lt;sup>30</sup> The risk that SJ-MPF would, if launched, not be used was small and anyway the cost at risk was small (~£1 million on development) versus the potential prize of over £100 million

<sup>&</sup>lt;sup>31</sup> See slides 8 and 11 of Openreach presentation LLU TAM – Selective 'In-Line' Deployment 23 July 2007

<sup>&</sup>lt;sup>32</sup> it is not clear whether CPs would need to pay separately and additionally for the TAM and tie cables D and E

- In any case, TalkTalk submitted an SOR for SJ-MPF in 2010 (and Openreach rejected it)
- 3.26 In the 2012 LLU Charge Control Statement Ofcom also raised a number of other objections to basing the price on MPF on the use of single jumpering. The key concern seems to be the implication that (if the price of DJ-MPF was based on the costs of single jumpering) then CPs would have no incentive to use a SJ-MPF product particularly since the rental price of the SJ-MPF product would not include the TAM cost (which would be purchased separately if a CP used SJ-MPF)<sup>34</sup>. This could result in a distortion in the choice of wholesale products. Ofcom described this as CPs having the 'best of both worlds' they could enjoy the lower cost of MPF that did not include the cost of TAMs but then not have to pay separately for TAMs.
- 3.27 We think that this perceived problem is not relevant now and/or surmountable. It should be recognised that a SJ-MPF product will probably not be launched (given Openreach's stance and Ofcom's dispute determination) and thus there is no need to create appropriate incentives for CPs to use a SJ-MPF product. Therefore, the primary purpose of setting the price of MPF should be to reflect the *average* cost CPs would have paid for MPF provision if Openreach had acted efficiently. In essence, Ofcom would set MPF prices on the basis of what costs would be if BT had and were acting efficiently. This is the same approach that Ofcom used in setting interconnection charges where they based on the costs on the basis of an NGN even though BT had not deployed one.
- 3.28 Under this approach the MPF price would reflect the following  $costs^{35}$ :
  - The cost of the SJ-MPF product (including a single jumper but excluding TAMs and tie cables)
  - The average costs CPs would have incurred in TAMs and tie cables to be able to use SJ-MPF reflecting the lower utilisation of TAMs/tie cables
- 3.29 In considering whether to set prices based on the use of SJ-MPF it is also relevant to consider the impact on incentives for BT to act efficiently. We believe that incentives will be improved by basing prices on the use of SJ-MPF. BT has already gained substantially in the past from not introducing SJ-MPF (and MPF charges therefore being set on the basis of inefficient costs). These gains will not be removed from BT if future prices are set on the basis of single jumpering<sup>36</sup>. However, setting prices at the efficient level will limit the illegitimate gain BT enjoys in future; this will increase the incentive on BT to act efficiently in the future and so will improve (but not eliminate) its incentive not to act against consumers' interests.

<sup>&</sup>lt;sup>33</sup> Similarly, though CPs could have used 21CN evoTAMs which would allow a single jumper arrangement again the CPs would no achieve any cost saving – the MPF rental price was the same and the evoTAM/tie cable added additional cost

<sup>&</sup>lt;sup>34</sup> §A9.41 2012 LLU Charge Control Statement

<sup>&</sup>lt;sup>35</sup> The MPF cost and price might also reflect that some lines would remain on DJ-MPF (see footnote 22 above)

<sup>&</sup>lt;sup>36</sup> unless there was retrospection – i.e. BT having to repay previous overcharge which might remove some (but not all) of the previous gains

3.30 Openreach may complain that an approach whereby prices are set on the basis of SJ-MPF will result in them not being able to recover their incurred costs (since they cannot migrate to using single jumpering without significant cost). However, such an approach is both necessary and justified. Setting prices at the efficient level improves allocative efficiency. Further, if prices were not set based on efficient costs it would allow BT to act against consumers' interests. That Openreach might not be able to recover its cost is squarely a result of its previous inefficient decision not to launch SJ-MPF, and it is important that BT bears the consequences of its actions. It is worth nothing that in other cases Ofcom does not allow BT to recover inefficient costs in regulated products e.g. assuming NGN costs (which are lower than BT's actual costs) to set interconnection prices.

#### 3.4 Options for setting the MPF price

- 3.31 The 'ideal' approach for setting MPF charges would be to remove the inefficient costs resulting from DJ-MPF, thereby reducing the MPF rental charge and removing the price premium for MPF (versus WLR) that results from the additional jumper (numbered 4 in the table below). This would both deliver the benefits of setting prices based on efficient cost levels and remove the competitive prejudice that MPF users would otherwise suffer. However there are other options open to Ofcom. We discuss these below.
- 3.32 One option (number 3) would be to equalise the frame costs as between MPF and WLR (i.e. set the incremental frame cost difference at zero rather than £2.90). This would allow BT to recover the additional inefficient jumpering costs resulting from using DJ-MPF rather than SJ-MPF, but remove the competitive distortion between MPF and WLR that has arisen from BT's inefficient behaviour, and so deliver improved customer benefits.
- 3.33 Another option (number 2) would be to correct the frame cost assumption as discussed in section 2 above.
- 3.34 The table below compares the 4 options, 1 being the current Ofcom approach. The column 'recover inefficient costs' reflects whether BT is able to recover the additional costs of DJ-MPF over SJ-MPF. The column 'incremental frame cost difference' is the assumed difference in frame cost as between WLR and MPF £2.90 as currently assumed, £1.10 as assumed in the SJ-MPF dispute, or zero which would remove the distortion

Option	Recover inefficient cost	Incremental frame cost difference	WLR rental	MPF rental	Differ- ence
1 – Ofcom current proposal	YES	£2.90	£89.90	£88.25	£1.65
2 – frame cost as dispute	YES	£1.10	£90.55	£87.10	£3.45
3 – no frame cost difference	YES	£0.00	£90.95	£86.40	£4.55
4 – costs at efficient level <sup>37</sup>	NO	£0.00	£90.55	£86.00	£4.55

Estimate of MPF/WLR price changes under different options

#### 3.35 Of com might also consider other price changes e.g.

- Resulting from only one less tie cable being required for SJ-MPF
- Changes in non-rental charges since the cost of migrations under single jumpering will be less than under double jumpering.

## 4 Ensuring BT compliance

- 4.1 As we highlighted in the introduction the potential development of SJ-MPF has been a rather tortuous affair over the last 7 years. Though SJ-MPF if launched early would have substantially reduced costs and delivered significant consumer benefits Openreach has refused to develop the product on several occasions which has delayed the potential introduction to the degree that introducing SJ-MPF now would not deliver any net cost savings. Openreach's obstructive behaviour is not perhaps surprising since SJ-MPF would not be in BT's interest because the net profit impact on BT Group from introducing SJ-MPF would have been negative.
- 4.2 The future harm from Openreach's behaviour could be partly mitigated *going forward* through disallowing inefficient costs and/or reducing the incremental frame cost difference. However, this would not repair the historic harm or disgorge from BT the full benefit of its anti-competitive behaviour. Even if Ofcom now sets MPF prices to reflect efficient costs BT will still have gained from its inefficient behaviour.
- 4.3 Therefore, we think that Ofcom need to consider how it can encourage BT to develop products that are in consumers' interests even when they are not in BT's commercial interests. It is worth noting that this misalignment of consumer and BT interests is not unique to SJ-MPF. Some of the generic reasons for a divergence of interests are:
  - If a development will expose more of the product/operation to competition;
  - when a development reduces CPs' costs allowing them to compete more effectively against BT's downstream operations; or,
  - when a product development allows BT's rival CPs to compete more effectively against other higher margin BT products;

<sup>&</sup>lt;sup>37</sup> Option 4 assumes (in line with dispute) the incremental frame cost reduction is £1.10 (not £2.90)

- 4.4 Some specific examples in addition to SJ-MPF of these include:
  - wires-only GEA is better for consumers / competition but is worse for Openreach since they can not monopolise provision the modem/installation (Openreach did eventually develop a product more than four years after it was first requested)
  - the business grade GEA SOR was largely rejected by Openreach even though it included functionality which would have made the product more suitable to business customers as an alternative to P2P Ethernet. Business grade GEA would cannibalise BT's leased line revenues and margins.
  - an LLU asset report SOR was requested by TalkTalk in March 2011. This simple development would reduce CPs' costs but not Openreach's. Openreach has taken over 2 years to develop this.
- 4.5 We discuss below some thoughts on how the product development process can be significantly improved through some additional targeted regulation / guidance. We have described this is more detail in TalkTalk's FAMR response.
- 4.6 We agree that product development requests should be managed through a mechanism such as the SOR. However, the current process is not fit for purpose and BT is able to frustrate the process and delay the launch of products that would benefit consumers. We see a number of areas for guidance on the SOR process.
- 4.7 Requiring that new products are <u>assessed on the appropriate basis</u> e.g. 'society-wide' benefits and not only benefits to Openreach. The assessment should also be on an incremental basis. Throughout the development of SJ-MPF Openreach assessed the benefits and net saving on the wrong basis.
- 4.8 Requiring that Openreach <u>conducts proper objective analysis</u>. Openreach has persistently declined to develop a sound analysis of the net savings from SJ-MPF:
  - In response to the 2010 SOR it appears that Openreach conducted no meaningful quantitative analysis;
  - In its response to the 2012 LLU Charge Control Consultation (in June 2011) it only quantified the additional costs and not the savings. Furthermore, it based this quantification a scenario that it knew to be unrealistic<sup>38</sup>
  - Even after the second 2012 SOR Openreach's analysis was (according to Ofcom) error-strewn and not fit-for purpose in that it incorrectly included revenue impacts, was not based on incremental costs, significantly overstated TASM volumes and costs, was incorrectly based on using evoTAMs and excluding frame cost savings. It did not even include a feasibility study (SJ MPF FD §A2.121)

<sup>&</sup>lt;sup>38</sup> Openreach's analysis was based on all new connections being provided on DJ-MPF which would result in stranded assets. Instead an expansion-only approach (which Openreach had proposed in 2007) is the obvious approach

- 4.9 It is notable that in the SJ-MPF dispute BT claimed that it was fully compliant on the basis that it followed its own self-prescribed process. 'Going through the motions' or following a bureaucratic box-ticking exercise is not enough to ensure that consumers' interests are met BT needs to conduct proper and objective analysis on the correct basis.
- 4.10 Making it clear that Openreach must <u>share full and complete information</u> regarding its assessment. Through the development of SJ-MPF Openreach has never given TalkTalk adequate reasons for its refusals or disclosed information that would allow resolution of disagreements. Our experience of submitting other SORs to Openreach is similarly that rejections come with little or no (cogent) explanation of the evidence that BT has relied on or its reasoning for reaching its decision. This makes effective engagement and commercial negotiation impossible. For example, Openreach refused to divulge any details of its model (either the 'coding' or assumptions). If this had happened TalkTalk could have highlighted Openreach's errors. One option that Openreach should be required to consider if it claims that the information is confidential is allowing independent consultants to review its assumptions.
- 4.11 Of commust be required to conduct proper analysis and share information in a <u>timely manner</u>.
- 4.12 Lastly, Ofcom should consider <u>incentives</u> so that the downside of not following guidelines and acting in consumers' interests is greater than the gains. As we explain above setting prices going forward at the efficient level does not fully remove from BT the gain from acting against consumers.
- 4.13 We think that this clarity can be provided through guidelines.
- 4.14 Lastly, we note that disagreements with Openreach regarding product developments are best resolved through the dispute mechanism rather than a market review or charge control. It was not until TalkTalk launched its recent dispute on single jumpering that Ofcom fully and quantitatively grappled with the net cost impact of SJ-MPF.

### 5 Conclusion

- 5.1 In summary, we consider that in light of the SJ-MPF dispute determination there are a number of implications on how the price of MPF is set in the LLU charge control and for BT's product development obligations.
- 5.2 First, if Ofcom is right to use £1.10 as the incremental frame cost difference per jumper in the context of the SJ-MPF FD, then the correct assumption is also £1.10 in the LLU charge control. Instead Ofcom has used £2.90 in the LLU charge control.

- 5.3 Second, MPF charges should be derived on the basis that SJ-MPF is widely used to provide MPF services<sup>39</sup> since:
  - Economic efficiency and competition is enhanced if charges are based on efficient costs (and not necessarily BT's actual approach / costs particularly since developing SJ-MPF was against BT's commercial interests)
  - BT could have reasonably known that SJ-MPF was more efficient in 2007 (or earlier) and if BT had acted efficiently then the majority of lines today would be provided using SJ-MPF
  - Setting charges in this way will improve BT's future incentives to act efficiently and in consumers' interests
- 5.4 Third, Ofcom should consider how it might provide guidance regarding the SOR process to ensure that BT has stronger incentives to act in consumers' interests in respect of product developments.

<sup>&</sup>lt;sup>39</sup> If Ofcom adopts this approach then the first issue regarding frame costs becomes irrelevant since Ofcom would effectively set the MPF frame cost to equal the WLR frame cost