LLU charge control

TalkTalk reply to BT response on price differential and Plum Consulting's report

Non-confidential version

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1 Summary

1.1 This paper responds to section 4 of BT's submission to Ofcom dated February 18th 2014, and the report by Plum Consulting ('**Plum**') on behalf of BT, dated February 2014, which address the question of the MPF vs WLR/SMPF price differential.

1.2 We deal with these two submissions together as they cover essentially the same topic. Both of them focus on the 'gap' between the incremental or LRIC[1] cost differential (as between MPF and WLR+SMPF) and the corresponding price differential – in 2016/17 Ofcom is proposing that the price differential should be £10 versus an estimated cost differential of £0 to £4, i.e. a gap of £6 to £10. In both of them BT (either directly or vicariously via Plum) alleges that this gap is in some sense a '*cross-subsidy*' to TalkTalk and Sky, which causes a market '*distortion*'. It further alleges that this distortion is of a very significant size (although BT's and Plum's submissions appear to disagree on the scale of the 'distortion') and also that closing the gap by aligning the price difference with the cost difference by 2016/17 – which will sharply increase MPF prices – will therefore be beneficial to overall levels of economic efficiency.

1.3 TalkTalk considers that BT and Plum both make numerous errors and omissions in their submissions, which lead to them being thoroughly misleading. These submissions provide no material relevant new evidence for Ofcom's consideration.

1.4 BT's submits that wholesale MPF prices can rise since TalkTalk's profit level is high. This is a perversion of the regulatory model. BT's proposal is tantamount to regulation of the downstream/retail market whereby retail returns are capped by raising wholesale prices (which allows above cost of capital returns by the wholesale monopoly). There is no legal, policy, or economic justification for Ofcom to extend the principles of regulation in this way. As a result, Ofcom should reject without further engagement all of the evidence and argumentation that BT puts forward for this as wholly irrelevant to Ofcom's duties.

1.5 In any event, and in addition to BT's flawed approach, BT's submissions are vitiated with errors, omissions and inaccuracies. TalkTalk profits and return on assets (currently less than [✂]) are far lower than BT suggests (24%). BT has proposed no model of pass-through in the downstream market, and presented no evidence which would support any assertion that we will have ability to absorb, rather than pass through, increases in MPF prices. [✂] *See Section 6 below.*

1.6 Amongst the other important errors and omissions are the following:

- Plum and BT both refer to there being a 'cross-subsidy', despite the fact that there is no cross-subsidy within any recognised economic sense since MPF prices are above their incremental cost. *See Section 2 below.*
- Aligning price differences with cost differences (referred to as 'alignment') will not create the allocative efficiency benefits that BT claims. In fact,

[1] We refer to the incremental cost difference as the LRIC difference. By LRIC we refer to its generic meaning of long run incremental costs rather than the specific LRIC figures in BT's RFS.

alignment will reduce some aspects of allocative efficiency and will increase competitive distortions since alignment will move MPF prices further away from incremental cost. Though alignment will move WLR/SMPF prices closer to incremental costs this is largely irrelevant since these products are principally consumed by BT who do not face external wholesale prices. *See Section 3 below*

- Ofcom's approach to alignment over about 6 years achieves a sensible balance between, on the one hand, the need for regulatory stability given the substantial investments by ISPs and, on the other, the regulatory goal of aligning price and cost differences in a context where there has been a significant (and wholly unforeseeable) reduction in the LRIC cost difference estimate. Plum's attempts to suggest that rapid alignment was prefigured in 2009 wilfully ignore the statements Ofcom made subsequently that alignment would happen over the 'long term'. EE's attempts to suggest that Ofcom is intentionally increasing the gap is a misrepresentation of the facts. *See Sections 4 and 5 below*
- Plum's estimate of a future 'distortion' of £369m is a significant over-estimate of the potential welfare loss given errors in its assumptions and straightforward economic mistakes. BT and Plum's implications that the 'distortion' equals a welfare loss is false. The actual harm is probably less than £30m (across 5 years) which is small compared to downstream investment of around £1.5bn a year that could be jeopardised if Ofcom reduces regulatory certainty and increases risk. *See Section 7 below*

1.7 There are also numerous other smaller (but still significant) errors and omissions in BT and Plum's submissions, which we detail and respond to below.

1.8 At various places we also set out comments on EE's response to Ofcom's consultation. In particular, we disagree with EE's conclusion that it would be inappropriate and in breach of Ofcom's legal duties to fail to align prices with LRIC differentials in the forthcoming charge control period. We rather consider that it would be in breach of Ofcom's duties to align prices on the basis of a one-off price adjustment (as EE recommends).

1.9 The remainder of this note sets out these positions in greater detail.

2 There is no cross-subsidy

2.1 BT and Plum both repeat continually throughout their submissions that there is a cross-subsidy which benefits purchasers of MPF products.[2] However, there is no cross-subsidy in any recognised economic sense.

2.2 A standard definition of a cross-subsidy is that given by Heald (1997):

[2] See BT's response, section 2, at paragraphs 24-25, and section 4, at paragraphs 4, 5, 24, 44, 45, 58, 63, 65, 67; the Plum report at pages 1, 2, 8, 9, 10, 12, 14, 18, and 19. In total Plum describe the gap as a 'cross-subsidy' 18 times and BT 12 times.

There is no cross-subsidy when the price of an output j is greater than or equal to its IC [incremental cost], and less than or equal to its SAC [standalone cost]. [emphasis in original][3]

2.3 This is the same definition as that used by Faulhaber (2005):

> *if the revenues of a regulated enterprise just cover total economic costs, then all prices are subsidy-free if the revenues of each service and each group of services is at least as great as the incremental cost of that service or group of services; equivalently, prices are also subsidy-free if the revenues of each service and each group of services is no greater than the stand-alone cost of that service or group of services.*[4]

2.4 It is clear that the price which Openreach currently sets for MPF rental is well in excess of incremental cost. As set out in the 2013 RFS, the LRIC for MPF rental in the year ended March 2012 was £64.61, while Ofcom is currently proposing to charge in the region of £85 per customer year.[5] MPF therefore is priced well above its incremental cost (and makes a substantial contribution to covering BT's common costs). There is no cross subsidy.

2.5 Effectively, BT and Plum appear to have redefined the meaning of 'cross-subsidy' for their own purposes. The way that they use this phrase is redolent of Humpty Dumpty in Through the Looking Glass:

> *when I use a word, it means just what I choose it to mean, neither more nor less* [6]

2.6 As such, it is misleading and factually incorrect for BT and Plum to assert in such a repeated way that there is a cross-subsidy. There is no such cross-subsidy, and the price of MPF is not even close to requiring a cross-subsidy. Rather, there is a difference in the level of common cost recovery as between MPF and WLR+SMPF. This has substantially different implications to a cross-subsidy, since whilst a cross subsidy is always distortionary and reduces allocative efficiency (unless the cross-subsidy offsets an externality) different levels of common cost recovery can be an economically efficient approach (for example if there are different elasticities of demand for various downstream products) and is an approach frequently advocated by BT[7].

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[3] Heald, D. (1997), *Public Policy towards Cross Subsidy*, Annals of Public and Cooperative Economics 68(4), pp. 591-623

[4] Faulhaber, G. (2005), *Cross subsidy analysis with more than two products,* Journal of Competition Law and Economics 1(3), pp. 441-448.

[5] The comparison should ideally be drawn using LRIC numbers for the year to March 2013. However, BT's RFS13 does not produce a LRIC figure for MPF rentals in this year, so we have here used the figure for the year to 2012. An alternative approach would be to take the figure for the year to March 2012 (£64.61) and add to it the year-on-year change in FAC (+£3.27) according to RFS13. This would lead to a LRIC estimate of £67.88. Adopting this alternative approach would change none of the conclusions in this section.

[6] Carroll, L. (1871), *Through the Looking Glass*, Chapter 6.

[7] For instance, most recently in an FTI report on the RFS for BT FTI argues that BT should have flexibility about how costs (and particularly common costs) are recovered from different products to reflect different demand conditions. For example, at §6.11 they say "*In constraining BT's ability to*

3 It is unclear that aligning prices with LRIC differentials will improve efficiency

3.1 BT's argument regarding the efficiency benefit of aligning prices with LRIC differentials is partial and internally inconsistent. We explain three flaws in BT's arguments below.

3.2 First, BT implies that the lack of demand evidence supports the same absolute level of common cost mark-up (which is the corollary of setting the price difference to equal the incremental cost difference). At §27, BT states:

> *As Ofcom notes, the suggestion that the fixed and common costs which need to be added to marginal costs should be allocated on the basis of demand elasticity can be rejected in this case as Ofcom recognises a lack of evidence regarding the required relative price elasticity of broadband over voice*.

3.3 BT does not cite any evidence which contradicts this position. Effectively, BT's position appears to be that there is no adequate evidence on elasticities of demand at a granular level, which would enable prices to be set in a Ramsey fashion.

3.4 However, where there is no evidence on elasticities of demand, this does not mean that equi-absolute mark-ups over LRIC maximise allocative efficiency. Rather, it means that the efficiency maximising allocation of common costs is unknown. It is disingenuous of BT simultaneously to state that TalkTalk's evidence should be disregarded due to a lack of support on elasticities of demand, while at the same time asserting (with a similar lack of evidence) that allocative efficiency is reduced by having different mark-ups over LRIC.

3.5 Second, allocative efficiency will be improved by having a lower mark-up for common costs on MPF rentals. BT asserts that:

> *For completeness, we also note that the cost-based differential is likely to be consistent with allocative efficiency, which is generally achieved when prices reflect marginal costs (where marginal costs may be defined as long run incremental costs)*.

3.6 We agree with BT that allocative efficiency is improved by prices being close to incremental cost. BT appears not to have understood the implications of narrowing the price differential and increasing the price of MPF on allocative efficiency. As the price of MPF is already above LRIC (see §2.4 above), a further price increase will move the price of MPF further away from incremental costs. That is, the first order effect of reducing the price differential will be to reduce allocative efficiency. Though the corollary of lower MPF prices is higher WLR+SMPF wholesale prices these increases are of limited impact on efficiency since the main user of WLR+SMPF products is BT itself and BT does not face the wholesale price, which is a notional internal transfer price from BT's perspective. Higher WLR+SMPF wholesale prices will only impact on that small part of the market that is external to BT and actually

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change cost allocation rules, Ofcom is effectively limiting BT's flexibility around how it recovers the costs of regulated products through prices."

purchases WLR+SMPF (such as EE[8]), which is only around 3-4% of the total broadband market. Therefore alignment will move prices further away from incremental costs for externally purchased products and reduce overall allocative efficiency.

3.7 There may be a second order effect on allocative efficiency which offsets this to some extent, but it is striking that BT does not even acknowledge that the primary impact of its proposal to close the gap would be to reduce allocative efficiency.

3.8 Third, competitive distortions will in practice be reduced by maintaining a gap, in order to keep MPF prices closer to incremental costs. This is because the main competitive actors in the UK market are BT (Retail), Sky, Virgin and TalkTalk. BT and Virgin both face the incremental costs of their networks when setting their prices. Competitive distortions will therefore be minimised if TalkTalk and Sky also faced the incremental costs, rather than a price materially above the incremental cost. By aligning the price differential with the cost differential MPF prices will move further away from incremental costs and therefore will increase competitive distortions in retail broadband.

3.9 Therefore, on the basis of both static efficiency concerns, and second best concerns, alignment will reduce allocative efficiency.

4 Ofcom's proposed approach does not increase the gap

4.1 EE implies (page 18 and Figure 1) that Ofcom is taking a deliberate decision to increase 'the price vs. LRIC distortion level' (i.e. the gap). This is disingenuous.

4.2 EE's argument reflects that Ofcom's estimate of the LRIC difference has reduced from £10-£14 to £0-£4 (we refer below to the mid-points i.e. that the estimate has reduced from £12 to £2). EE then compares:

- the current price difference (£19) to the previous cost difference estimate £12 – a gap of £7;
- to the proposed 2014/15 price difference (£13) to the revised cost difference estimate £2 – a gap of £11.

4.3 EE uses this to suggest that Ofcom is intentionally increasing the gap and then goes on to argue for the gap to close immediately, by means of a one-off pricing adjustment. This is a false comparison since (based on the new cost evidence) the current 2013/14 gap is £17 (£19 less £2) and Ofcom are closing the gap to £11 in 2014/15. A £6 reduction in the gap in a single year is significant.

4.4 It is useful to understand how the gap has arisen and why it is appropriate to close it over a long period. A key reason is that Ofcom's cost difference estimate has fallen substantially between 2012 (when it was £10-£14) and 2014 (£0 to £4). This is effectively an exogenous 'shock' to the regulatory regime. This new evidence should

[8] EE purchase WLR and IPStream – however, the price of IPStream effectively reflects the SMPF price.

obviously not be ignored but equally neither should it be immediately fed through into prices without proper consideration of the consequences. If such a shock was fed through into prices immediately (as EE argues) it would result in significant regulatory instability, and therefore an increase in perceived regulatory risk. Rather, such a shock should be fed through slowly in order to avoid instability. In TalkTalk's view, such an exogenous shock is exactly the type of 'compelling reason' that the CC would have had in mind when setting out the acceptable reasons for why Ofcom might change regulatory approach such as extending the period over which alignment occurs.[9]

4.5 We believe that Ofcom's proposed approach, which provides regulatory predictability but allows prices to align with costs over a reasonable timeframe, is an appropriate one in the circumstances. Contrary to EE's assertions, such a decision is well within Ofcom's margin of regulatory appreciation. EE appears, by stating that Ofcom will '*have committed a serious legally reviewable error*' if there is not an immediate price adjustment so that the differential between MPF and WLR is no more than £8.14, to be making an implicit threat of appealing Ofcom's proposed decision. We consider that this is little more than empty rhetoric by EE.

5 Ofcom had not prefigured a rapid closing of the gap

5.1 Plum continually highlights Ofcom's position in 2008 and 2009, including a quote in May 2009 that '*prices should move to the underlying FAC by 2012/13*'. However, Plum wilfully ignores what Ofcom said after 2009, presumably because Ofcom's regulatory position evolved in the intervening period, and that quotes from Ofcom documents in these years are not helpful to BT's case. There is no meaningful relevance to citing quotes from 2009 which have been superseded by later evolution of Ofcom's policy. As set out in TalkTalk's submission dated February 2014 at §6.13, Ofcom's position had indeed evolved in the intervening period, such that in the LLU charge control appeal in late 2012 Ofcom stated that alignment of the price differential and LRIC differential would occur in the '*long term*' which is palpably different to what it said in 2009. Plum's appeals to earlier Ofcom statements to support their incorrect assertion that regulatory predictability is best ensured by aligning prices with LRIC differentials immediately are therefore irrelevant.

5.2 [✂]

6 MPF rental increases would be passed on to consumers and/ or reduce investment

6.1 §§53-60 of BT's submission deal with TalkTalk's profitability; BT seeks to suggest that TalkTalk has very high profitability and can easily absorb a rapid increase in MPF

[9] Competition Commission (2013), *British Telecommunications plc v Ofcom* and *British Sky Broadcasting Limited and TalkTalk Telecom Group plc v Ofcom: Determinations*, March 27, at para 7.138 *et seq*.

prices (without passing through increases in retail price rises). In it, BT advances a number of specious arguments, which show little understanding of TalkTalk's financial position, and selectively quote statistics in order to give an erroneous impression of TalkTalk's overall financial state.

6.2 Moreover, even if BT's figures were accurate, we consider that Ofcom should still attribute no weight to them. The approach adopted by BT– of determining what wholesale charges TalkTalk can afford to pay, based on a quasi-regulatory model– is inappropriate, and represents an attempt to convince Ofcom to cap retail returns for BT's downstream competitors. BT has presented no evidence that TalkTalk has the market power which would allow sustained supernormal profits to be earned. We present a full rebuttal below, including of the figures presented. However, this should in no sense be taken as TalkTalk acknowledging that we think that the approach adopted in BT is at all relevant to Ofcom's assessment. We believe that it should be dismissed and given no weight.

6.3 [✂]

6.4 [✂]

6.1 BT has misrepresented TalkTalk's profitability and ROCE

6.5 BT's analysis is, in two key respects, incorrect.

6.6 First, TalkTalk's EBIT is considerably lower than BT states in its submissions. We note that BT has not used TalkTalk's most recent half-year financial report (which is publicly available on our website), or analysts' projections of our current profitability, but has instead gone back to our financial year ended March 2013.

6.7 Headline EBIT in the first six months of the current financial year was £18m, down by over 80% from the preceding year's £95m.[10] Thus currently our (annualised) return on assets is only 3.4%, rather than the 23.5% alleged by BT –calculated on the basis of £36m annual EBIT (that is, 2 x £18m), and the same figure for non current assets used by BT (£1,046m). A 3.4% return on assets would clearly be below TalkTalk's cost of capital.

6.8 As such, BT has effectively taken a snapshot of TalkTalk's profits, which provides an unrepresentative picture. The latest information demonstrates a considerably lower ROCE than that presented by BT, which is not consistent with TalkTalk having the ability to pay increased charges without knock-on effects on consumers (through pass through of charges) or investment. BT has failed to reflect in its analysis the key principle that returns should be assessed over the long term, and that the shorter the snapshot used, the more likely that misleading results will be obtained.

6.9 [✂][11][✂]

[10] TalkTalk Group, *Interim Results for the six months to 30 September 2013*, page 11.
[11] [✂]

6.10 Third, even were BT's assessment to be accurate (which it is not), BT is failing appropriately to split returns between different markets. BT is implicitly assuming that all of the returns, and potential for increased EBITDA margins in the medium term, are due to MPF. [✂] BT has not provided information on what it considers TalkTalk's rate of return is for retail broadband products.

6.2 BT is effectively attempting to price regulate TalkTalk

6.11 BT suggests that given TalkTalk's high profitability it is reasonable to raise wholesale prices (§§53-60). This amounts, in our view, to an attempt to encourage Ofcom to engage in price regulation of TalkTalk and Sky so that where, in BT's view, profits are 'excessive' Ofcom should cap these profits by means of increasing wholesale charges. This is inappropriate, against consumers' interests, and would be in breach of Ofcom's duties.

6.12 BT has applied a standard regulatory framework for its analysis in this section. It has taken a capital base, then taken EBIT profits, and therefore determined an approximate ROCE measure. This has implicitly been compared to a measure of cost of capital (§56). BT then reaches a conclusion that there is "*no case that high returns are needed over the period 2014/15 onwards to recover start-up/ entry costs*". It then goes on to effectively suggest that TalkTalk returns are capped by means of increasing wholesale MPF prices.

6.13 BT's approach is therefore a perversion of the regulatory model. There has been no finding that TalkTalk has market power– with a market share of less than 20%, and ownership of no assets which could constitute a monopolistic bottleneck, we do not believe that a finding of market power could rationally be reached.[12] Therefore it is neither appropriate nor legal to regulate TalkTalk's (or other ISPs') activities.

6.14 Therefore, it is not appropriate for regulators to cap the returns of downstream firms so that they can only earn their cost of capital. It is even less appropriate to cap downstream returns by increasing wholesale prices, which would allow network monopolists such as BT to earn supernormal profits. Furthermore, the approach that BT appears to be advocating would allow BT Openreach to expropriate any efficiency gains made by TalkTalk, destroying incentives to innovate in order to lower costs. It would also create barriers to entry in both the short and long term, as potential entrants would face asymmetric risks– if they made losses, those would have to be absorbed, but as soon as returns exceeded the cost of capital (even if to pay back earlier losses) BT would argue that this created capacity for wholesale prices to rise, capping downstream profits. An efficient entrant would therefore be supporting the inefficient costs of a monopolist. As such, Ofcom giving any weight to BT's analysis of

[12] This contrasts with all other players in the UK telecoms market. For example, BT owns the Openreach access network (a sunk asset which would cost billions of pounds to replicate); Virgin Media also owns an access network covering around 45% of UK homes (which would also cost billions of pounds to replicate); Sky has ownership of unique sports rights and a very high market share in markets such as premium sports channels and

profitability would not be in accordance with Ofcom's duties to create competitive market conditions and only regulate where market power is found.

6.3 BT Retail's returns are in excess of its cost of capital

6.15 In any event, and in addition to BT's flawed approach, if Ofcom wishes to give any weight to BT's argument at §§53-60, then it is important also to consider the ROCE of BT's analogous downstream businesses (i.e. the unregulated, non-Openreach parts of the business). While BT has estimated TalkTalk's pre-tax return on assets at 23.5% ([✂]), BT's ROCE has consistently been well above this level.

6.16 This can be seen by a review of the RFS. Section 5.1 of RFS13 sets out BT's ROCE for their different business lines. In that section, "Retail residual activities" are shown to have a ROCE of 937%, while even taking "Wholesale residual activities" and "Retail residual activities" together (which is potentially a closer representation of TalkTalk's business activities) gives a ROCE of 61.6%. That is, BT's returns are about 20 times as high as those for TalkTalk currently (and about three time what they were for TalkTalk last year).

6.17 If BT thinks that downstream ROCE levels are relevant (which TalkTalk disagrees with) then BT's very high downstream ROCE could have a number of implications such as:

- MPF prices are excessive due to, for example, BT having gamed its regulatory accounts by transferring costs from downstream operations to Openreach,;
- as BT is obviously and substantially less efficient than TalkTalk in its retail operations, there is not a level playing field and that competitors are discriminated against;
- there are barriers to switching which BT is benefitting from, permitting BT Retail to earn supernormal profits.

7 Plum has over-estimated consumer harm

7.1 The Plum report provides an estimate of the size of the 'distortion' caused by prices not being aligned with LRIC differentials – £623m in the past and £369m potentially over the next six years, and implies that these amounts are in some sense a welfare loss to consumers. Plum's logic and assumptions are wrong on several levels and the actual harm to consumers is probably less than £30m.

7.2 Any estimate of the historic 'distortion' is irrelevant to the question of appropriate regulation going forward. Therefore, it is unclear why the figure is included at all except to try and bulk up the media impact of the Plum report. In any event, the figure is over-estimated since it assumes that the LRIC cost differential has been £2 (based on the most recent estimate) at all points in time, and ignores the larger estimates previously made by Ofcom.

7.3 Regarding the future distortion figure there are further significant flaws. We explain our view on these below.

7.4 First, the submissions of Plum, BT and EE are all predicated on the 'true' LRIC differential being £2. However, this significantly underestimates the appropriate LRIC differential. As set out at section 5 of TalkTalk's February 2013 response to Ofcom's December 19th consultation, there are a range of other factors which have not properly been taken into account in determining a LRIC differential of £0 to £4. These include:

- not reflecting that MPF ILFs are lower than WLR+SMPF ILFs (and also incorrectly taking the costs of early life faults (ELFs) into account when calculating rental cost differentials);
- an overestimate of the incremental cost of TAMs;
- an inappropriate assumption that incremental MPF service assurance costs are twice as high as WLR+SMPF;
- an underestimate of PSTN line card costs;
- an incorrect estimate of the incremental frame operating cost for additional jumpers.

7.5 As such, TalkTalk has demonstrated that the appropriate LRIC differential is not £0 to £4, but £5 to £6. This would give a mid-point of £5.50, £3.50 higher than the estimate used by BT, Plum and EE. We estimate that using the £5.50 figure (rather than the £2 figure) would reduce the value of the gap by about 40%.

7.6 Second, Plum have used a wholly inappropriate counterfactual – they have calculated the total 'distortion' based on a comparison of an immediate alignment of the price differential (i.e. by July 2014) and cost differential and an alignment over 6 years (i.e. by April 2019). An immediate alignment would be incompatible with Ofcom's approach of using glidepaths (and thus result in a significant increase in uncertainty and regulatory risk) and, as far as we can discern, it has not been suggested by BT. Using a counterfactual of alignment over three years, rather than over six years, would reduce the counterfactual to somewhere in the region of £200m, based on Plum's figures.[13]

7.7 Third, the 'distortion' estimate is (as we explained in our previous submission) absolutely not the same as the welfare loss. Ofcom have previously said that the price difference is the 'extreme upper bound' of the welfare loss. In fact, as we point out above at Section 3, there are welfare benefits (e.g. increased allocative

[13] This can be seen from Table 6-1 of the Plum report, which sets out that there is a "static welfare loss" of £115m from alignment over three years for existing MPF lines, but immediate alignment for new MPF lines. This figure of £115m will need to be increased to reflect the impact of new MPF lines also being aligned over time. It is hard to determine exactly what the magnitude of such increase should be, but it seems likely to lead to an estimate slightly less than half of the overall "static welfare loss" (as the number of MPF lines is increasing over time). We therefore believe that £200m for the remaining "welfare loss" is appropriate.

efficiency, reduced competitive distortion, dynamic gains[14]) from having a gap since MPF wholesale prices are closer to LRIC; although a gap will result in WLR/SMPF wholesale prices being further from LRIC this is largely irrelevant since the main user of WLR/WMPF does not face the wholesale price.

7.8 Using the better estimate of the LRIC differential and using the correct counterfactual would sharply reduce the alleged 'distortion' or 'cross subsidy' which is claimed in the various submissions. Taking this into account and also that the welfare loss will be only a proportion of the 'distortion' we estimate that the actual harm is probably less than £30m (across 5 years).

- Starting figure for gap: £369m
- Use correct counterfactual: £200m
- Use £5.50 cost difference: £120m
- Assume that *net* welfare loss from gap (taking into account economic benefits from gap) is 25% of gap: welfare loss £30m or £6m a year

7.9 This £6m a year loss compares to an investment of £1.5bn a year that could be jeopardised if Ofcom reduces regulatory certainty and increases risk. If downstream retail providers consider that their returns are at risk due to regulatory changes, they could make significant reductions investments in consumer acquisition. This would soften competitive tensions in retail markets, and would therefore tend to increase consumer prices.

8 Other issues

8.1 In this section we comment on a number of other issues raised in the BT, Plum and EE submissions.

8.1 There is no risk of price adjustment remaining in place until 2024/5

8.2 BT's comments at §§6-7 of its February 18th submission are partial and misleading. BT attempts to argue that the pace of alignment of the differential is too slow, and that there is a risk that alignment will not occur until the 2021/2 to 2024/5 regulatory period.

8.3 That this relies on a logical fallacy can be seen simply. Plum Consulting notes on page 1 of its report that:

> *Ofcom estimate that the cost difference between MPF and WLR+SMPF is around £2 per annum, whereas the price difference is £19 per annum*

8.4 While BT notes at §6 that Ofcom proposes that

[14] In particular those resulting from deeper competition which result in more innovation and investment and competitive pressure over more of the value chain

a Price Differential of £10 is maintained by the end of the control period.

8.5 As such, the differential is reduced from £19 to £10 over the course of the forthcoming regulatory period– a reduction of £9. As BT and Plum appear to believe that the appropriate differential is £2 (§7 of BT's submission), then Ofcom is proposing to remove over half of the differential in the current regulatory period.

8.6 It is therefore risible to suggest, in a situation where over half of the differential is being removed over the first three years, that a period of six years is likely to prove insufficient to remove the whole differential. BT is selectively taking parts of the charging profile in order to mislead Ofcom and reach erroneous conclusions. Ofcom should reject such sophistry.

8.2 Changes to WLR product

8.7 TalkTalk notes that in the current regulatory review, Ofcom is proposing to change the definition of the WLR product to remove directory related costs from WLR, and removing those costs of evoTAM testing from the SMPF product. This is set out by BT at §§32-33 of section 4 of its submission.

8.8 To the extent that Ofcom wishes to take these changes in product definition into account over a short period of time (whether that it over the three years of the upcoming review period, or if Ofcom were to wrongly adopt the approach of a one-off price adjustment) these changes in product definition should only affect the price of WLR and SMPF. That is, if Ofcom wishes to reflect them (for instance by immediately reducing the cost difference), they should lead to the price of WLR/SMPF falling more quickly, without changing the price path of MPF. This follows from the principle of cost causality– where there are changes to the WLR product, but no changes to the MPF product, then there should be changes to the WLR price, but no changes to the MPF price.

8.3 BT's analysis of TalkTalk investment is partial

8.9 BT's analysis of the potential impact of an MPF rental increase solely considers investments made in unbundling exchanges (see §§35-44). [✂]